(2)

No. 89-393-CFX
Status: GRANTED

Title: Harry P. Begier, Jr., etc., Petitioner
v.
Internal Revenue Service

Docketed:
September 11, 1989

Court: United States Court of Appeals
for the Third Circuit

Counsel for petitioner: Winterhalter,Paul J.

Counsel for respondent: Solicitor General

Entry	Date	Note	Proceedings and Orders
1	Sep 11 1989	G	Petition for writ of certiorari filed.
3	Oct 12 1989		Order extending time to file response to petition unti November 11, 1989.
4	Nov 16 1989		Order further extending time to file response to petition until December 7, 1989.
5	Nov 27 1989		Brief of respondent United States in opposition filed.
7	Nov 29 1989		REDISTRIBUTED. January 5, 1990
8	Jan 8 1990		Petition GRANTED. and the parties are directed to adhe to the following briefing schedule. The brief of petitioner must be received by the Clerk on or before February 9, 1990. The brief of respondent must be received by the Clerk on or before March 6, 1990, and a reply brief, if any, must be received by the Clerk on c before March 16, 1990.
			**********
9	Jan 26 1990		SET FOR ARGUMENT TUESDAY, MARCH 27, 1990. (3RD CASE)
10	Feb 9 1990		Joint appendix filed.
11	Feb 9 1990		Brief of petitioner Begier filed.
12	Feb 12 1990		Record filed.
		*	Certified copy of briefs, appendix and partial proceedings received.
13	Feb 21 1990		Record filed.
		*	Certified copy of original record received.
14	Mar 2 1990		CIRCULATED.
15	Mar 6 1990	X	Brief of respondent United States filed.
16	Mar 27 1990		ARGUED.

89-393

No.___

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1989

HARRY P. BEGIER, JR., Trustee,

Petitioner

v.

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE,

Respondents

On Petition for Writ of Certiorari
to the United States Court of Appeals
For the Third Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Whether Congress, in enacting the Bankruptcy Code in 1978, intended the mere fact of payment of funds from a bank account which may be covered by a statutory trust be sufficient to exclude the funds from the property of the estate that is subject to avoidance as preferential transfers under Section 547 of the Bankruptcy Code?

LIST OF PARTIES TO THIS PROCEEDING

Your Petitioner in the instant proceeding is Harry P. Begier, Jr., the duly appointed Chapter 11 Bankruptcy Trustee in the Bankruptcy matter of American International Airways, Inc.[1] which proceeding was originally commenced in the United States Bankruptcy Court for the Eastern District of Pennsylvania under Case Number: 84-02379K on July 19, 1984. The Respondent in this proceeding is the United States of America, Internal Revenue Service.

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1. American International Airways, Inc. is a wholy owned subsidiary of AIA Industries, Inc., both entities of which filed bankruptcy proceedings under Chapter 11 in July of 1984. AIA Industries, Inc. Bankruptcy was filed on July 23, 1984 under Case Number 84-02411.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES – *(Continued)*

No.____

IN THE

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October Term, 1989

HARRY P. BEGIER, JR., Trustee,

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v.

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE,

Respondents

On Petition for Writ of Certiorari
to the United States Court of Appeals
For the Third Circuit

PETITION FOR WRIT OF CERTIORARI

OFFICIAL CITATION TO DECISION BELOW

Harry P. Begier, Jr., Trustee v. United States of America, Internal Revenue Service, Appellant, 878 F.2d 762 (3rd Cir. June 30, 1989, *as amended* July 13, 1989, *rehearing denied* July 28, 1989), 58 U.S.L.W. 2032, 89-2 U.S.T.C. Page 9416.

STATEMENT OF JURISDICTION

Your Petitioner appeals from the Opinion and Order of the United States Court of Appeals for the Third Circuit filed on June 30, 1989 and as amended on July 13, 1989. A Petition for Rehearing pursuant to Federal Rule of Appellate Procedure 40(a) and Suggestion for Rehearing en banc was denied by the Third Circuit by Order dated July 28, 1989.

Original jurisdiction for the proceeding in the Bankruptcy Court was founded on 28 U.S.C. Section 1334(b) and 28 U.S.C. Section 157(b)(2)(F). Appellate review by the District Court was based on 28 U.S.C. Section 158(a) and by the United States Court of Appeals for the Third Circuit pursuant to 28 U.S.C. Section 158(d) and Section 1291.

This Petition for a writ of certiorari is brought pursuant to 28 U.S.C. Section 1254(1).

STATUTES AT ISSUE

Section 547 **PREFERENCES**

* * *

(b) except as provided in Subsection (c) of this Section, the Trustee may avoid any transfer of property of the Debtor–

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the Debtor before such transfer was made;

(3) made while the Debtor was insolvent;

(4) made–

(a) on or within ninety (90) days before the date of filing the Petition; or

(b) between ninety days and one year before the date of filing of the Petition, if such creditor at the time of such transfer–

(i) was an insider; and

(ii) had reasonable cause to believe the Debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such creditor would receive if–

(a) the case were a case under Chapter 7 of this title;

(b) the transfer had not been made; and

(c) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. Section 547(b)(1982)[1]

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1. As noted by the Court of Court of Appeals in their decision in the instant case, 11 U.S.C. Section 547(b) was amended in 1984, although the earlier version is applicable to this case. Public Law No. 98-353, Title III, Sections 310, 462 July 10, 1984, 98 Stat. 355, 378 was made applicable only to cases commenced ninety days following enactment. Since this case was filed on July 19, 1984, the 1982 provisions of the Bankruptcy Code apply. *Begier v. United States*, 872 F.2d 762, ____ (3rd. Cir. 1989) (Appearing at Page 6 of Official Opinion.)

Section 541 **PROPERTY OF THE ESTATE**

(a) The commencement of a case under Section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

* * *

(7) Any interest in property that the estate acquires after the commencement of the case.

* * *

(d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

11 U.S.C. Section 541. (1982)

Section 7501 **LIABILITY FOR TAXES WITHHELD OR COLLECTED.**

(a) General rule.

Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

26 U.S.C. Section 7501 (1984).

STATEMENT OF CASE

Your Petitioner respectfully requests this Court review a Decision rendered by the United States Court of Appeals for the Third Circuit which reversed a Decision of the United States District Court affirming a Final Order of the United States Bankruptcy Court by The Honorable David A. Scholl, United States Bankruptcy Judge. The Petitioner herein is the Court appointed Chapter 11 Bankruptcy Trustee in the matter of American International Airways, Inc., which proceeding is pending in the United States Bankruptcy Court for the Eastern District of Pennsylvania. The original action was commenced by the Trustee seeking to avoid four transfers made by the Debtor Corporation, hereinafter referred to as "Debtor" to the Internal Revenue Service, hereinafter referred to as "IRS" as preferential transfers pursuant to 11 U.S.C. Section 547(b).

The facts critical to the matter were never in dispute and were largely established before the Bankruptcy Court by a Stipulation of facts submitted by the parties and made a part of the record at trial.[3] Additionally, the Bankruptcy Court made specific findings of fact which were expressly incorporated in the Bankruptcy Court Opinion.[4]

The Debtor was a commercial airline that provided passenger and air cargo service to the Eastern and Central United States. As a regular employer of individual taxpayers, the Debtor was required to withhold and pay on a quarterly basis certain employment taxes, specifically the employee's share of withholding taxes and the employee's share of Federal Insurance Compensation Act taxes. The Debtor was also required to pay the employer's share of the FICA assessment. Additionally, as an airline carrier, the Debtor was subject to certain Federal Excise taxes collected from airline passengers. These taxes were all required to be paid by the Debtor to the IRS.

By the first quarter of 1984, the Debtor had become delinquent in the filing and the payment of its Social Security,

3. A copy of the Stipulation is attached and included in the Appendix to this Petition.

4. *Begier v. IRS*, 83 B.R., 324, 326-7 (Bkrtcy. E.D. Pa. 1987).

Federal Income and Excise taxes in an amount which approximated One Million Five Hundred Thousand Dollars ($1,500,000). As a direct result of the poor filing and payment history of the Debtor, the IRS issued a notice pursuant to 26 U.S.C. Section 7512 requiring the debtor to file its return on a monthly basis. The Appellant further required the Debtor to establish a special account for future deposit of all tax obligations. These notices were delivered by mail on February 22, 1984 and personally served upon a principal of the Debtor on March 1, 1984.

In response to the notices, the Debtor established a specially designated tax account on March 6, 1984 and deposited sums therein on March 22, March 30, April 13, and April 17, 1984 which payments totalled Six Hundred and Ninety Five Thousand and Fifty One Dollars and Forty Two Cents ($695,051.42). From this designated account, the Debtor on April 30, 1984 drew Six Hundred and Ninety Five Thousand Dollars ($695,000) and transferred these sums directly to the IRS. This payment was accompanied by a check from the Debtor's general operating account in the amount of Seven Hundred and Forty Six Thousand, Four Hundred and Thirty Four Dollars ($746,434). These payments were transmitted with a letter from the Debtor Corporation specifically directing the application of the monies to varying tax obligations for specific periods. The application of these monies as directed by the Debtor was subsequently confirmed by the Revenue Officer of the Internal Revenue Service responsible for the delinquent entity.

Additional transfers were paid out of the Debtor's general operating account by check dated June 22, 1984 in the amount of Two Hundred Thousand Dollars ($200,000) and then subsequently by check dated June 24, 1984 in the amount of Eleven Thousand, Six Hundred and Thirty Six Dollars and thirty five cents ($11,636.35). On each occasion the delivery of the payments was accompanied with a specific direction from the Debtor designating the application of the payment to specific taxes due.

The Trustee, during the administration of the bankruptcy proceeding, instituted this action against the Internal Revenue Service seeking to avoid the three transfers from the Debtor's operating account as preferential payments made by the Debtor. Following a trial on the merits and in full consideration of the Stipulation of the parties submitted previously thereto, the Bankruptcy Court found the Trustee entitled to avoid Seven Hundred Thousand, Four Hundred and Ten Dollars ($700,410) as preferential transfers made by the Debtor to the IRS. *Begier v. United States Internal Revenue Service,* 83 B.R. 324, 333 (Bkrtcy. E.D. Pa. 1988).

Based on the facts as stipulated, the IRS acknowledged before the Bankruptcy Court that the Trustee had established the requisite elements for avoidability under 547(b). The IRS unsuccessfully argued, however, that the three transfers at issue should be excepted from avoidance pursuant to a certain affirmative defense included in the Statute under Section 547(c)(2). The Bankruptcy Court ruled that the IRS failed to carry its affirmative burden in establishing each element of the defense and granted judgment in favor of the Trustee. *Id.* at 328, 333. The Bankruptcy Court decision was affirmed by the District Court in an unreported decision. *Begier v. United States Internal Revenue Service,* No. 88-3529 (D. E.D. Pa. August 15, 1988) (Donald W. VanArtsdalen, J.).

On Appeal to the Third Circuit Court of Appeals, the IRS relinquished its argument regarding the affirmative defense and instead pursued an issue which originally was summarily disposed in the Bankruptcy Court. The IRS argued before the Court of Appeals, by operation of law, a statutory trust imposed under the Internal Revenue Code in Section 7501 should take precedent over the Bankruptcy Code whereby any payment for withholding taxes to the government, regardless of the source, removed the property from being considered part of the Debtor's estate thereby precluding avoidability.[5]

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5. Section 547(b) of the Bankruptcy Code requires that a Trustee may only avoid transfers which are the property of the estate. 11 U.S.C. Section 547(b)(1982).

The Third Circuit analyzed this issue the same as have several Courts who have previously addressed the point. The Court found the terms included in the Statute to be lacking clear directive therefore looked to the legislative history for further guidance. The majority Opinion of The Third Circuit adopted the rationale set forth in the dissenting Opinion by The Honorable Ruth Ginsburg in *Drabkin v. District of Columbia* 824 F. 2d 1102 (D.C. Cir. 1987). The Court below concluded that certain wording in the legislative history mandated special treatment for withholding taxes. While the Court acknowledged that the Internal Revenue Service would not be able to sidestep the Trustee's power to avoid non-trust fund payments such as corporate income taxes, federal unemployment taxes or the employer's share of FICA taxes, it found the ability of the Debtor to make a pre-petition payment on account of withholding taxes, regardless of the source of the funds used to make the payment, impressed with trust characteristics removing the property from the Debtor's estate.

The Third Circuit thereon directed the instant case be remanded to the District Court for findings consistent with the Court's ruling. Upon the entry of the Order, your Petitioner promptly filed a Petition for Rehearing pursuant to Federal Rule of Appellate Procedure 40(a) and a Suggestion for Rehearing en Banc pursuant to Federal Rule of Appellate Procedure 35(a). Both the Petition for Rehearing and Rehearing en Banc were denied by the Court by Order dated July 28, 1989. This petition follows.

ARGUMENT FOR ALLOWANCE OF WRIT

A. The Decision Of The Court Of Appeals For The Third Circuit Creates A Direct Conflict Between Circuits.

It is respectfully presented that a writ of certiorari should be granted by Your Honorable Court in this proceeding. The majority decision of the Third Circuit Court of Appeals creates a direct conflict with an earlier decision of the United States Court of Appeals for the District of Columbia Circuit in the case *Drabkin v. District of Columbia, supra.* The conflict is so direct

that the majority opinion of the Third Circuit expressly adopts the position taken by the dissenting Opinion of the Court of Appeals for the District of Columbia. Judge Hutchinson in the case at bar expressly adopts as its Dissenting Opinion the majority Opinion taken in the same *Drabkin* case.

It has been well established in this Court that Certiorari should be granted where there is a clash of opinions between Courts of Appeals preventing a uniform course of decision made on the same question. *Universal Camera Corp. v. NLRB,* 340 U.S. 474, 71 S. Ct. 456, 95 L. Ed. 456 (1951); *Rice v. Sioux City Memorial Park Cemetery Co., Inc.,* 349 U.S. 70, 75 S. Ct. 614, 99 L. Ed. 897 (1955); *Goldlawr, Inc. v. Heiman,* 369 U.S. 463, 82 S. Ct. 913, 8 L. Ed. 2d 39 (1962). The rationale in support of unified findings by the Courts of Appeals is to avoid divergent conclusions throughout the lower Federal Courts. *Id.* This point is self-evident by the several decisions which have emerged from various Bankruptcy Courts attempting to address the exact issue which is in dispute in this case.[6]

The conflict on the issue is further magnified when considering that of the six judges from the two Courts of Appeals who have considered and ruled upon the issue, three judges have interpreted the legislative history behind the Bankruptcy Code in one way while three others have interpreted the same language exactly opposite. This undoubtedly leaves profound confusion for future interpretation on this issue by any Federal Court. It is critical for this Court to provide uniform direction to the lower Federal Courts.

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6. Compare *Drabkin v. District of Columbia, supra; United States v. Daniel,* 79 B.R. 22 (D.Nev. 1987); *In re Olympic Foundry Co.,* 63 B.R. 324 (Bkrtcy. W.D. Wash. 1986) *rev'd on other grounds,* 71 B.R. 216 (9th Cir. 1987); *Schwartz v. Comm. of Pa.,* 75 B.R. 676 (Bkrtcy. E.D. Pa 1987) *remanded for clarification, slip. opinion* No. 87-4934 (E.D. Pa July 12, 1988); *with In re Rodriquez,* 50 B.R. 576 (Bkrtcy. E.D.N.Y. 1985); *In re Razorback Ready-Mix Concrete Co.,* 45 B.R. 917 (Bkrtcy E.D.Ark. 1984).

B. The Theory Supporting The Majority Opinion Of The Third Circuit Is Opposite Prior Rulings Of This Court.

While this Court has never had the opportunity to address whether a Trustee in Bankruptcy may under Section 547(b) of the Bankruptcy Code avoid pre-petition payments to the Internal Revenue Service on account of federal withholding taxes, the court has had an opportunity to analyze portions of the issue in related circumstances. This Court has on no fewer than three occasions examined whether the imposition of a trust pursuant to Section 7501 of the Internal Revenue Code may remove property from a bankruptcy estate. In each case the court found the imposition of the trust may not be used to remove the property from the debtor. The underlying rationale in these earlier cases should be applied to the case at bar.

In *United States v. Randall,* a case decided under the former Bankruptcy Act, this Court ruled that 26 U.S.C. Section 7501(a) could not be used to impress a trust upon funds held by a bankrupt debtor corporation subsequent to the filing of the bankruptcy petition. *United States v. Randall,* 401 U.S. 513, 91 S.Ct. 991 (1971). The Court found the statutory policy of subordinating taxes to the costs and expenses of administration would not be served by creating or enforcing trusts which eat up an estate leaving little or nothing for creditors and court officers whose goods and services create the assets. *Id.,* 401 U.S. at 516, 91 S.Ct. at 994. The Court ruled that the funds then in the possession of the Debtor could not be found as a trust in favor of the Federal government inasmuch as this claim must succumb to an "overriding statement of Federal policy on questions of priorities." *Id.,* 401 U.S. at 415 91 S.Ct. at 993.

A few years following *Randall,* this Court had another occasion to review 26 U.S.C. Section 7501 in the bankruptcy context. In *U.S. v. Slodov,* this Court ruled that a trust under 26 U.S.C. Section 7501 cannot be impressed on after acquired funds. *United States v. Slodov,* 436 U.S. 238, 98 S.Ct. 1778, 56 L.Ed. 2d. 251 (1978). This Court found that "under Section 7501 there must be nexus between the funds collected and the trust created. That construction is consistent with the accepted

principal of trust law requiring tracing of misappropriated trust funds into the trustee's estate in order for an impressed trust to arise". *Slodov, Id.*, 436 U.S. at 256, 98 S.Ct. at 1790 citing to D. Dobbs, *Handbook on the Law of Remedies*, 424-425 (1973). *Randall* and *Slodov* have been cited repeatedly for requiring the IRS to establish a nexus between the funds withheld from employee's paychecks and the monies held by the employer in order to establish the impressed trust. The failure of the taxing authority to trace this connection precludes the imposition of the trust.

In a case decided under the Bankruptcy Reform Act of 1978, this Court has further ruled that property of the estate includes property of the debtor that had been seized by the Internal Revenue Service prior to the filing of the bankruptcy petition. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 208-9, 103 S.Ct. 2309, 2315, 76 L.Ed. 2d. 515 (1983). The essence of this Court's ruling in *Whiting Pools* recognized that the taxing authority must protect its interest according to the Congressionally established bankruptcy procedures, rather than, in that case, by withholding seized property from a debtor's efforts to reorganize. *Id.*, 462 U.S. at 212, 103 S.Ct. at 2317.

The Third Circuit differentiated the previous rulings by this Court by emphasizing in its Opinion below that those cases decided under the Act involved transactions in which the IRS was seeking to obtain funds from a debtor post-petition. The Third Circuit believed Congress when enacting the 1978 Bankruptcy Code intended the tracing burden only be applied to funds held as of the commencement of the case. This conclusion, however, fails to consider this Court's ruling in *Whiting Pools* which enabled a debtor to recover property which had been seized by the IRS prior to the filing of the petition. While *Whiting Pools* did not turn on the effect of 26 U.S.C. Section 7501, it did express this Court's opinion that the Internal Revenue Service should be treated no differently than any other creditor. To the extent they held a possessory interest, that interest was subjected to the priorities Congress imposed in preserving a bankrupt debtor's property.

The effect of the Third Circuit's Opinion would be to deny the ability of a bankruptcy trustee to avoid as preferential transfers any pre-petition payments made to the Internal Revenue Service on account of withholding taxes despite the time when the payment was made. Such a result was not the contemplation of Congress. The conclusion of the Third Circuit and the Dissenting Opinion in *Drabkin* is erroneous because their ruling is founded on language from the House Report before it was modified by the Floor Managers' Compromise Legislation. If Congress truly intended to impose a restriction on the avoidability by a bankruptcy trustee of all pre-petition payments on account of trust fund taxes, it could have expressly provided for such exemption in the statute.

As emphasized by the majority Opinion in *Drabkin*, the Senate Report originally precluded the avoidability of all tax payments. The subsequent House Amendment modified the statute to its then current state and omitted the absolute preclusion to avoid tax payments. What it allowed, however, is subject to dispute. The confusion caused by what Congress truly intended requires review by this Court to resolve this important legal issue.

CONCLUSION

For the foregoing reasons, Petitioners respectfully request Your Honorable Court to issue a Writ of Certiorari to review the judgment and Opinion of the United States Court of Appeals for the Third Circuit as entered in this matter.

Respectfully submitted,

CIARDI, FISHBONE & DIDONATO

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APPENDIX

APPENDIX

TABLE OF CONTENTS

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 88-1788

HARRY P. BEGIER, JR., *Trustee*

v.

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE,

Appellant

(D.C. Civil No. 88-3529)

SUR PETITION FOR REHEARING

Present: GIBBONS: *Chief Judge,*
HIGGINBOTHAM, SLOVITER, BECKER,
STAPLETON, MANSMANN, GREENBERG, HUTCHINSON,
SCIRICA, COWEN AND NYGAARD, *Circuit Judges*

The petition for rehearing filed by appellee in the above-entitled case having been submitted to the judges who participated in the decision of this Court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular service not having voted for rehearing, the petition for rehearing by the panel and the Court in banc, is denied. Judge Hutchinson would grant rehearing.

BY THE COURT

Circuit Judge

Dated: July 28, 1989

Filed June 30, 1989

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 88-1788

HARRY P. BEGIER, JR., *Trustee*

v.

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE,

Appellant

Appeal from the United States District Court
For the Eastern District of Pennsylvania
(D. C. Civil No. 88-3529)

Argued January 31, 1989

Before HUTCHINSON, SCIRICA *and* NYGAARD,
Circuit Judges

(Opinion filed June 30, 1989)

William S. Rose, Jr., Assistant Attorney
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OPINION OF THE COURT

SCIRICA, *Circuit Judge.*

This case presents the question whether § 547 of the Bankruptcy Code allows a bankruptcy trustee to avoid as preferential transfers, payments of non-segregated funds to the Internal Revenue Service by the debtor during the pre-bankruptcy petition period in satisfaction of the debtor's tax withholding obligations.

The Internal Revenue Service appeals from a judgment of the district court upholding a decision of the bankruptcy court permitting appellee Harry P. Begier, Jr., the trustee in bankruptcy of debtor American International Airways, Inc., to recover pre-petition withholding tax payments from American International's general operating account. The bankruptcy court determined that the payments were transfers of property of the debtor's estate, not transfers of funds held in trust for the IRS under § 7501 of the Internal Revenue Code. For reasons that follow, we hold these payments, transferred to the IRS before American International's bankruptcy petition was filed, to be a special fund in trust for the government under I.R.C. § 7501 and not recoverable as preferential transfers of the debtor's property. Therefore, we will reverse.

The facts in the case are not disputed. Debtor, American International Airways, Inc., was in the airline business. By the spring of 1984, it had become delinquent in remitting social security and income taxes withheld from employee wages, as well as excise taxes collected from airline passengers, to the United States. On March 1, 1984, the IRS notified American International of this delinquency and required it to file monthly (as opposed to quarterly) returns of its wage withholding and excise taxes, and to open a separate bank account to receive these tax deposits in trust for the IRS.[1]

On March 6, 1984, American International opened a bank trust account and made deposits of wage withholding and excise taxes. On April 30, 1984, American International paid the IRS $695,000 from the separate trust account and $734,798 from its general operating bank account. On June 22 and 27, 1984, it made two more payments from the general operating account of $200,000 and $11,636, respectively. Thus, American International made payments to the IRS of $695,000 from the separate trust account and $946,434 from its general operating account, for a total payment of $1,641,434. All payments were allocated by agreement between American International and the IRS to specific social security, income withholding and transportation excise taxes due from January 1984 to April 1984, except for the payment of $11,636 which was allocated to 1982 and 1983 excise taxes.

On July 19, 1984, American International filed a petition in bankruptcy under Chapter 11 of the Bankruptcy Code. For three months thereafter, the debtor attempted to operate the business as a debtor-in-possession, but failed. Consequently, the bankruptcy court appointed a trustee and the case was converted to a liquidation under Chapter 7 of the Bankruptcy Code. The trustee then filed this adversary proceeding to recover the $1,641,434 tax payments as voidable preferences under 11 U.S.C. § 547(b).

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1. In the event of delinquency, the IRS may require collection of the tax and deposit in a separate account. I.R.C. § 7512.

The bankruptcy court did not allow the trustee to recover the transfer of $695,000 from the separate withholding tax account, holding that this was a transfer of funds held in trust, rather than from the debtor's estate. *Begier v. United States Internal Revenue Service*, 83 B.R. 324, 327 (Bankr. E.D. Pa. 1988). This decision has not been appealed. However, the bankruptcy court determined that the trustee could recover as preferential transfers the $946,434 in payments made from the debtor's operating account, less $246,024.[2] In total, the court allowed the trustee to avoid $700,410 out of the $1,641,434 sought. *Id.* at 328. In explaining why it had treated as voidable preferences the transfers from the general operating account, the court reiterated the conclusion it had drawn in previous cases that, "only where a tax trust fund is actually established by the debtor and the taxing authority is able to trace funds segregated by the debtor in a trust account established for the purpose of paying the taxes in question would we conclude that such funds are not property of the debtor's estate." *Id.* at 329 (*citing In re American Airlines, Inc.*, 70 B.R. 102, 105 (Bankr. E.D. Pa. 1987); *In re Rimmer Corp.* 80 B.R. 337, 338-89 (Bankr. E.D. Pa. 1987)). By order dated, August 15, 1988, the district court affirmed the decision of the bankruptcy court. This appeal followed.

II.

As we have noted, we must decide whether §547(b) of the Bankruptcy Code allows a bankruptcy trustee to avoid as preferential transfers, payments of non-segregated funds transferred from the debtor's general operating account to the IRS during the pre-bankruptcy petition period on account of the debtor's tax withholding obligations. Whether withheld taxes paid pre-petition to the IRS from non-segregated funds commingled with other funds of the debtor are avoidable preferences depends on whether the funds are considered to be property of the debtor's estate or held to be in trust for the IRS.

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2. The court denied recovery of the latter amount because either it was not paid on account of antecedent debts or because it was paid in the ordinary course of business.

The IRS argues that withheld taxes, paid pre-petition, are deemed to have been held in trust for the government under §7501 of the Internal Revenue Code. The trustee responds that because the withheld taxes were commingled with the other funds rather than placed in a separate account, they may not be designated as trust funds and may be recovered.

A.

Section 547(b) of the Bankruptcy Code allows the trustee in bankruptcy to recover payments on account of antecedent debts made by the debtor immediately prior to the filing of a bankruptcy petition:

§547. Preferences

* * *

(b) Except as provided in subsection (c) of this section.

the trustee may avoid any transfer of property of the debtor –

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made –

(A) on or within 90 days before the date of the filing of the petition; or

(B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer –

(i) was an insider; and

(ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such creditor would receive if –

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. §547(b) (1982).[3] Section 547(c) of the Bankruptcy Code provides a transferee creditor with defenses to a preference action brought by the trustee. 11 U.S.C. §547(c).[4] Thus, to prevail in a preference action, the trustee must prove that a transfer of "property of the debtor" took place and that the transfer met the criteria listed in §547(b). In addition, the trustee must overcome any 547(c) defenses raised by the transferee. Funds held in trust do not constitute "property of the debtor," and therefore are not recoverable as a preference under §547(b). *See* 11 U.S.C. §541(d).[5]

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3. 11 U.S.C. §547(b) was amended in 1984, although the earlier version is applicable to this case, *See* Pub. L. No. 98-353, Title III, §§310, 462, July 10, 1984, 98 Stat. 355, 378.

4. Former §547(c), applicable to this case, provided in pertinent part:

(c) The trustee may not avoid under this section a transfer –

* * *

(2) to the extent that such transfer was –

(A) in payment of a debtor incurred in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made not later than 45 days after such debt was incurred;

(C) made in the ordinary course of business or financial affairs of the debtor and the transferee;

(D) made according to ordinary business terms . . . .

11 U.S.C. §547 (1982). Section 547(c)(2) was amended in 1984. *See* Pub.L. No. 98-353, Title III, §462, July 10, 1984, 98 Stat. 355, 378. The amendment struck out, *inter alia*, subparagraph (B), which read "made not later than 45 days after such debt was incurred." Pub.L. No. 98-353, §462(c).

5. 11 U.S.C. §541(d) provides:

(d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage

Here, the IRS does not contest that the trustee meets the criteria listed in Section 547(b); rather, it argues that the payments were not "transfer[s] of property of the debtor" because the payments represent money held in trust for the IRS pursuant to Section 7501, and as such, are simply not subject to Section 547(b). Section 7501(a) provides:

> §7501. Liability for taxes withheld or collected
>
> (a) General rule. — Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

I.R.C. §7501.[6] If a person required to collect or withhold any internal revenue tax from any other person under I.R.C. §7501 fails to collect, account for, or pay over such tax, the IRS may require that person to collect the tax and deposit the amount in a separate bank account. I.R.C. §7512. Thus, §7501 itself does not require segregation of withholding taxes, unless the IRS, finding the employer delinquent in paying over the taxes, demands that the funds be placed in a separate account.

B.

Because of the complicated legislative history and statutory authority in this case, we believe it would be helpful to track the development of the status of withholding tax payments in bankruptcy. Prior to the passage of the 1978 Bankruptcy Act, the seminal case addressing the status of withholding taxes in bankruptcy was *United States v. Randall*, 401 U.S. 513 (1973). In *Randall*, the IRS sought to collect withholding taxes in possession of the debtor after the commencement of the case in bankruptcy and which the debtor had failed to segregate into a separate trust account as required by court order. *Id.* at 514. After dissolution of the corporation, the IRS, arguing that I.R.C. §7501 created a statutory trust, requested the bankruptcy court to pay the amount of withheld taxes to the government before the payment of costs and expenses of administration of the estate, *Id.* at 514-15. The Supreme Court upheld the bankruptcy court's refusal to pay over the withheld taxes, finding that the Bankruptcy Act is an overriding statement of federal policy on bankruptcy priorities, and that "the statutory policy of subordinating taxes to costs and expenses of administration would not be served by creating and enforcing trusts which eat up an estate, leaving little or nothing for creditors and court officers whose goods and services created the assets," *Id.* at 516-17.

Several years later, in another pre-1978 Bankruptcy Act case, the Court found that I.R.C. §7501 does not impose a trust for funds acquired post-petition absent tracing of those funds to taxes collected. *Slodov v. United States*. 436 U.S. 238, 256 (1978). In *Slodov*, the corporation had dissipated its funds pre-petition, and was unable to meet its withholding tax obligations. *Id.* at 242. After the corporation filed for bankruptcy, the

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secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

6. Congress passed I.R.C. §7501 (originally §607 of the Internal Revenue Code) to provide the IRS with more effective tax collection methods:

> Existing law provides with respect to a number of taxes that the amount of the tax shall be collected or withheld from the person primarily liable by another person, who is required to return and pay to the Government the amount of the taxes so collected or withheld by him. . . . Under existing law the liability of the person collecting and withholding the taxes to pay over the amount is merely a debt, and he can not be treated as a trustee or proceeded against by distraint. Section [606] of the bill as reported impresses the amount of taxes withheld or collected with a trust and makes applicable for the enforcement of the Government's claim the administrative provisions for assessment and collection of taxes.

S. Rep. No. 558, 73d Cong., 2d Sess. 53 (1934).

We note that the air transportation excise taxes and the withheld employee income taxes in this case are taxes that American International was "required to collect or withhold . . . and to pay over to the United States" under §7501(a), and thus both are subject to the disposition of this appeal.

government argued that the Internal Revenue Code imposed a trust on funds acquired post-petition for the payment of the overdue withholding taxes. *Id.* at 254. The *Slodov* Court concluded that to construe §7501 to impose a trust on property acquired post-petition, when no nexus had been established between that property and the taxes "withheld or collected" under I.R.C. §7501, would conflict with the priority rules in bankruptcy. *Id.* at 255-56. We believe it is significant that both *Randall* and *Slodov* addressed whether the IRS could collect withholding taxes held post-petition.

In 1978, Congress enacted a new Bankruptcy Code. In enacting §541 of the 1978 Bankruptcy Code, Congress allowed "reasonable assumptions" in tracing, thus relaxing the strict tracing requirement required by courts applying *Randall*:

> As to withheld taxes, the House amendment deletes the rule in the Senate bill as unnecessary since property of the estate does not include the beneficial interest in property held by the debtor as a trustee. Under the Internal Revenue Code of 1954 (section 7501), the amounts of withheld taxes are held to be a special fund in trust for the United States. Where the Internal Revenue Service can demonstrate that the amounts of taxes withheld are *still in the possession of the debtor at the commencement of the case,* then if a trust is created, those amounts are not property of the estate.
>
> Where it is not possible for the Internal Revenue Service to demonstrate that the amounts of taxes withheld are *still in the possession of the debtor at the commencment of the case*, present law generally includes amounts of withheld taxes as property of the estate. *See, e.g., United States v. Randall*, 401 U.S. 513 (1973), . . . Nonetheless, a serious problem exists where "trust fund taxes" withheld from others are held to be property of the estate where the withheld amounts are commingled with other assets of the debtor. The courts should permit the use of reasonable assumptions under which the Internal Revenue Service, and other tax authorities, can demonstrate that amounts of withheld taxes are still in the possession of the debtor at the commencement of the case. . . .

124 Cong. Rec. 32417 (Sept. 28, 1978) (statement of Representative Edwards); 124 Cong. Rec. 34016-17 (Oct. 5, 1978) (statement of Senator DeConcini) (emphasis added) (some citations omitted). Thus, for withholding taxes held as of the commencement of the case, i.e. *post-petition*, Congress relaxed the strict tracing requirement required by courts applying *Randall* and allowed the use of "reasonable assumptions" to trace funds paid to the IRS on account of withholding tax obligations to taxes actually withheld by the corporation.[7]

The status of withholding tax payments accrued and paid *pre-petition* was also considered and addressed by Congress in the legislative history of the 1978 Bankruptcy Act. Specifically, Congress addressed whether the trustee in bankruptcy could avoid as preferential transfers pre-petition payments of withholding taxes under §547 of the Bankruptcy Code:

> This provision [§547] will not apply to permit the trustee to recover estimated tax payments by a debtor, because no tax is due when the payments are made. Therefore, the tax on account of which the payment is made is not an antecedent debt. A payment of withholding taxes constitutes a payment of money held in trust under Internal Revenue Code §7501(a), and thus will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payments.

H.R. Rep. No. 595, 95th Cong., 1st Sess, 373 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 6329.

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7. *But see In re Miller's Auto Supply Co.*, 75 B.R. 676, 680 n.4 (Bankr. E.D. Pa. 1987) (declining to hold that *Randall* has been overruled by 11 U.S.C. §541(d) and stating that *Randall* still has continuing vitality).

C.

Several bankruptcy courts have considered whether this passage from the House Report protects pre-petition withholding tax payments to the IRS from avoidance when the payments were not made from a specific trust fund established for the benefit of the IRS, but rather were made from the debtor's general operating account. *Compare In re Rodiguez*, 50 B.R. 576 (Bankr. E.D.N.Y. 1985) (if debtor is able to make the withholding tax payment pre-petition, taxes paid must be labeled as trust funds and are protected from avoidance) *and In re Razorback Ready-Mix Concrete Co.*, 45 B.R. 917 (Bankr. E.D. Ark. 1984) (same) *with In re Olympic Foundry Co.*, 63 B.R. 324 (Bankr. W.D. Wash. 1986) (trustee may avoid all pre-petition withholding tax payments made pursuant to state law that were not drawn from a separately established tax account), *rev'd on other grounds*, 71 B.R. 216 (Bankr. 9th Cir. 1987) *and In re Miller's Auto Supplies, Inc.*, 75 B.R. 676, 679-81 (Bankr. E.D. Pa. 1987) (following *Olympic*).

In 1988, in a carefully detailed opinion, the question whether pre-petition payments of withholding taxes from the debtor's general operating account constitute avoidable preferential transfers under §547(b) was squarely addressed by the Court of Appeals for the District of Columbia Circuit in *Drabkin v. District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987). In *Drabkin*, the bankruptcy trustee sought to recover as preferential transfers under §547(b) withholding tax payments made pre-petition to the District of Columbia by the debtor, Auto-Train Corporation.[8] The bankruptcy and district courts found

8. The District of Columbia Code created a statutory trust for withheld employee income taxes: ". . . [a]ny sum or sums withheld in accordance with the provisions of this section shall be deemed to be, and shall be, held in trust by the employer for the District." D.C. Code Ann. §47-1812.8(f)(1)(1980). The *Drabkin* court found that §7501(a) of the Internal Revenue Code "essentially mirrors the [statutory trust] provision on which the District . . . relies." 824 F.2d at 1105.

In the case *sub judice*, we decide only that funds paid to the IRS pre-petition are held to be a special fund in trust under I.R.C. §7501. This section is specifically mentioned in the legislative history of 1978 Bankruptcy Code. We do not address the status of taxes withheld pursuant to state law. *Cf. In re Miller's Auto Supplies, Inc.*, 75 B.R. 676, 680 (Bankr. E.D. Pa. 1978).

that the payments were avoidable transfers under §547(b). Based on its reading of the legislative history of the Bankruptcy Code, the panel, in an opinion written by Judge Douglas Ginsburg, affirmed and held that the mere pre-petition payment of non-segregated funds did not exclude those funds from property of the estate and thus found them subject to recovery as a preference. *Id.* at 1103. Judge Ruth Bader Ginsburg dissented, concluding that the debtor's pre-petition ability to make the tax withholding payments placed the trust beneficiary in a class separate from other creditors and thus removed the payment from the category of preferences voidable by the trustee. *Id.* at 1118 (Ruth B. Ginsburg, J., dissenting).

Because *Drabkin* is so closely analogous to this case, the trustee urges us to follow the *Drabkin* majority, while the IRS argues that the *Drabkin* dissent is compelling. For reasons that follow, we find the *Drabkin* dissent convincing, and generally follow Judge Ruth Bader Ginsburg's analysis.

D.

In her dissenting opinion, Judge Ruth Bader Ginsburg phrased the central issue in the case: "Does section 547 of the Bankruptcy Code . . . empower the bankruptcy trustee to recover funds transferred to tax authorities during the pre-petition period in satisfaction of the debtor's withholding tax obligation?" *Drabkin*, 824 F.2d at 1117 (Ruth B. Ginsburg, J., dissenting) (citation omitted). The dissent resolved this issue based on the language of the House Report that accompanied the House version of the 1978 Bankruptcy Code. As we have previously noted, the House Report states:

> A payment of withholding taxes constitutes a payment of money held in trust under Internal Revenue Code §7501(a), and thus will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for

payment, as they will have been if the debtor is able to make the payments.

1978 U.S. Code & Admin. News at 6329. According to the dissent, the meaning of the Report's final words ". . . if they have properly been held for payment, as they will have been if the debtor is able to make the payments," clearly means that, "if the debtor is able to make the payment, the taxes 'have been properly held for payment,' which places the trust beneficiary in a class separate from other creditors and thus removes this payment from the category of preferences avoidable by the trustee." *Id.* at 1118 (citing *In re Rodriguez*, 50 B.R. 576, 581 (Bankr. E.D.N.Y. 1985); *In re Razorback Ready-Mix Concrete Co.*, 45 B.R. 917, 922 (Bankr. E.D. Ark. 1984)). We agree with this analysis.

While acknowledging that the debate over avoiding pre-petition payments of withheld taxes had centered primarily on this House Report,[9] the *Drabkin* majority discounted the Report's statement concerning the avoidability of pre-petition withholding tax payments under §547(b) because the passage did

9. The IRS has argued that the House Report supports the conclusion that the payment of withheld taxes to the government from a debtor's general operating account serves to identify those payments as funds held in trust, thus insulating them from avoidance by the trustee in a preference action.

As the *Drabkin* majority observed, courts that have considered the House Report have focused on the final words of the passage: ". . . if they have been properly held for payment, as they will have been if the debtor is able to make the payments." *See Drabkin*, 824 F.2d at 1110-12. Two courts faced with the issue found dispositive the Report's language ". . . as they will have been if the debtor is able to make the payments," thereby holding for the taxing authority on the grounds that, if the debtor is able to make the payment, the monies would be labled trust funds and the debtor's duty as trustee regarded as completed. *E.g., In re Rodriguez*, 50 B.R. at 581: *In re Razorback Ready-Mix Concrete Co.*, 45 B.R. at 922. On the other hand, a third court found dispositive the language ". . . if they had properly been held for payment," thereby allowing the trustee to avoid all pre-petition payments of withholding taxes to the state that were not drawn from a separately established fund. *In re Olympic Foundry Co.*, 63 B.R. at 328.

The *Drabkin* majority declined to rely on either the *Rodriguez-Razorback* analysis or the *Olympic Foundry* analysis *See Drabkin*, 824 F2d at 1110-12 (disapproving analysis based on legislative "snippets").

little to clarify what the majority considered the central issue in the case: whether the transfer was of estate property as defined by §541 of the Bankruptcy Code or whether the transfer was of trust funds.[10] According to the *Drabkin* majority, "[i]f the House intended this passage to provide criteria for determining when property is considered within the debtor's estate and when it is held in trust, we would expect to find the passage in its commentary on section 541, which defines what property is included within the debtor's estate . . . ."[11] *Drabkin*, 824 F.2d at 1112. The court determined that "one reaches the question of whether a payment is for an antecedent debt only after having concluded that funds were property of the estate [as defined in §541] at the time of payment." *Id.*[12]

10. The dissent disagreed with the *Drabkin* majority for transforming a §547(b) preferential transfer case into a case in which section 541's definition of 'property of the estate' becomes the central focus. 824 F.2d at 1118 (Ruth Bader Ginsburg, J. dissenting). Indeed, the dissent postulated that "the question the majority poses – 'whether the payment was of estate property or of trust funds' – was not the issue Congress wanted courts to resolve when faced with *pre-petition* withholding tax payments." *Id.* at 1119 (citation omitted; emphasis in original). The dissent explained:

> True enough, '[i]f the funds in question were trust funds' – i.e. were not 'property of the estate' under section 541 – 'their pre-petition payment [could] never be a voidable preference.' Court's opinion at 1112. It does not follow as the night the day, however, that if the funds were property of the estate, then the pre-petition payment would be a voidable preference.

Id. at 1118-19 (Ruth B. Ginsburg, J, dissenting).

11. The *Drabkin* majority found unconvincing the House Report's discussion of withholding taxes under §547(b) because it was in the "wrong place" in the Report. Furthermore, it believed the passage to be only an elaboration of the observation that precedes it regarding tax payments made on account of an antecedent debt. 824 F.2d at 1112. We disagree. The passage specifically refers to a payment of withholding taxes as "a payment of money held in trust" with respect to which the taxing authority is "in a separate class," and therefore evinces Congress's intent to treat withholding taxes differently than other taxes. Given the passage's broad implication, we find that it is plainly more than an elaboration on the relationship between the timing of the payment and the incurrence of the debt.

12. The court explained:

> The fact that the much contested passage arises in a discussion of the

The IRS asks us to find that withheld taxes transferred pre-petition may not be defined as "property of the estate." In particular, the IRS argues that the language of the House Report discussing §547(b) reflects congressional intent that the pre-petition payment of withholding taxes identifies those taxes as funds held in trust. As funds held in trust, they could not be defined as "property of the estate" under §541, and consequently their transfers could not be avoided as preferential under §547(b).[13] As we have noted, the *Drabkin* majority declined to interpret the House Report discussion of §547(b) in this manner because it appeared in the "wrong place" in the legislative history.

However, we believe that the placement of this passage in the Report's discussion of §547(b) rather than in the discussion on the definition of "property of the estate" under §541 does not diminish its relevance. We find that the House Report's discussion of §547(b) indicates that, at least pre-petition, the act of payment of withholding taxes identifies those taxes as funds held in trust. As funds held in trust, these withholding taxes paid pre-petition are not property of the estate under §541.

NOTES *(Continued)*

section 547 preference rules strongly suggests (1) that the House did not intend it to illuminate what constitutes a trust under section 541, and (2) that pre-petition payments of withheld taxes might qualify as voidable preferences, at least under some circumstances.

Drabkin, 824 F.2d at 1112.

13. The Bankruptcy Code does not define the phrase "property of the debtor" found in §547(b). Therefore, courts have looked to whether the transferred property may be defined as "property of the estate" under §541. Indeed, to constitute a preference under §547(b), a transfer must deprive the debtor's estate of property that could otherwise be used to satisfy creditors. *In re Newcomb*, 744 F.2d 621, 626 (8th Cir. 1984); *see also* 4 *Colliers on Bankruptcy* ¶547.03[2] (1989) ("A transfer is preferential only if the property or the interest in property transferred belongs to the debtor. . . . The fundamental inquiry is whether the transfer diminished or depleted the debtor's estate.").

The *Drabkin* majority also identified other portions of the Bankruptcy Code's legislative history as illustrative of congressional intent regarding pre-petition payments of withholding taxes, including the Committee Report's discussion of section 547(c):

> In the tax content, this exception [§547(c)] will mean that a payment of taxes when they are due, either originally or under an extension, or within 45 days thereafter, will not constitute a voidable preference. However, if a payment is made later than the last day on which the tax may be paid without penalty, then the payment may constitute a preference, if the other elements of a preference are present. In that case, the tax debt would be an antecedent debt and would not fall under this exception. However, the trustee would be able to recover only if the taxing authority did not have sovereign immunity or had waived it under proposed 11 U.S.C. 106.

1978 U.S. Code Cong. & Admin. News at 6329. The trustee asks us to find, as the *Drabkin* majority found, that this passage makes clear that Congress intended, in some circumstances, for pre-petition tax payments to be recoverable as voidable preferences. 824 F.2d at 1113. The *Drabkin* majority explained that the Report's commentary on §547(c) quoted above, when read in conjunction with the Report's discussion of §547(b), manifests legislative intent that the phrase "as they will have been if the debtor is able to make the payments" made in the Report's commentary on §547(b) "presupposes payments made before a penalty is incurred, *not* whenever the debtor happens to make the payment."[14] *Id.* (emphasis in original).

14. Accordingly, because the tax payments at issue in *Drakin* were made by Auto-Train months after the taxes had become due, and were not protected from avoidance under §547(c)(2) because they were made within 45 days after the payments were due, the *Drabkin* court allowed the trustee to recover as preferential the tax payments made by Auto-Train prior to its petition for bankruptcy. The court continued: "When the payment occurs after that 45-day period, as here, it qualifies as a voidable preference under §547(b)-(c) *unless* the funds used are traceable to a trust and therefore excluded from the debtor's estate under section 541." 824 F.2d at 1115 (emphasis in original).

We find, however, that the Report's discussion of §547(c) makes no distinction between taxes on income earned by the debtor itself and taxes of others withheld by the debtor. In contrast, the House Report's discussion of §547(b) directly addresses the issue of withholding taxes. As the *Razorback* court explained, taxes that an employer has an obligation to withhold from others are distinguishable from the taxes on income earned by the employer:

> [Withholding] taxes are ordinarily never considered property of the employer having the duty to withhold. Initially, the tax monies are the property of the employees from whose wages the monies are withheld, and after the withholding is accomplished, 26 U.S.C. Section 7501(a) provides that the monies belong to the United States and are held in trust by the employer.

45 B.R. at 920; *see also In re Rodriguez*, 50 B.R. at 581; *Kalb v. United States*, 505 F.2d 506, 509 (2d Cir. 1974) (in paying withholding taxes over to the government, the employer merely surrenders that which does not belong to him), *cert. denied*, 421 U.S. 979 (1975); Heffron, *Fraud in Withholding*, 18 Inst. on Fed. Tax. 1073, 1076 (1960) ("The gross wages belong to the employee; but for the intervention of [withholding tax] law all would be paid to him."); *cf. In re Ribs-R-Us, Inc.*, 828 F.2d 199, 200 (3d Cir. 1987) (withheld taxes commonly referred to as "trust fund taxes"). Thus, withholding taxes are distinguished from taxes directly incurred by the debtor. Indeed, the IRS does not dispute that payments of non-"trust fund taxes," such as corporate income taxes, Federal Unemployment Tax Act taxes, and the employer's share of FICA taxes, would be subject to a preference action. We believe our holding reflects a proper consideration of the distinct nature of withholding taxes.

E.

In a similar way, the *Drabkin* majority did not distinguish between pre-petition payment of withheld taxes and a post-petition action by the IRS to recover withheld taxes in the possession of the estate. Focusing on the legislative history of

§541, the *Drabkin* majority found that Congress intended to relax *Randall's* strict tracing requirements to allow courts to permit the use of "reasonable assumptions" under which taxing authorities may demonstrate that amounts of withheld taxes are in the possession of the debtor at the commencement of the case. 824 F.2d at 1106. The *Drabkin* majority then concluded that, in the context of the case before it concerning pre-petition payments of withholding taxes, the question presented involved "the precise extent to which Congress relaxed [the tracing] requirement" through the use of "reasonable assumptions."[15] 824 F.2d at 1112. Finally, the court determined that the reasonable assumption, rather than the strict tracing rule of prior law should govern, and held that it was not a reasonable assumption to " 'conclusively presume that the funds used for payment necessarily are endowed with trust characteristics.' " *Id.* (citing Olympic Foundry, 63 B.R. at 329).

The dissent found inapposite the majority's emphasis on the "reasonable assumption" tracing burden imposed by Congress in response to the *Randall* case. *Drabkin*, 824 F.2d at 1119 (Ruth B. Ginsburg, J., dissenting). We agree. We believe that, when Congress relaxed *Randall's* tracing requirement to allow courts to use "reasonable assumptions" to trace funds, it intended the reasonable assumption tracing burden to apply post-petition only. This is clear from the legislative history: "The courts should permit the use of reasonable assumptions under which the Internal Revenue Service, and other tax authorities, can demonstrate that amounts of withheld taxes are still in the possession of the debtor at the commencement of the case." *See supra* statements of Representative Edwards and Senator DeConcini.

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15. The *Drabkin* majority addressed the question whether the "reasonable assumption" tracing requirement would apply to pre-petition withholding tax payments after concluding that, "when the [withholding tax] payment occurs after [the] 45-day period [under §547(c)(2)(B)], . . . it qualifies as a voidable preference under section 547(b)-(c) *unless* the funds used are traceable to a trust and therefore are excluded from the debtor's estate under section 541." 824 F.2d at 1112.

III.

We conclude, in accordance with congressional intent embodied in the legislative history, that the debtor's pre-petition payments on account of its tax withholding obligations are held to be a special fund in trust for the IRS for the government under I.R.C. §7501 and are not preferential transfers of the debtor's property under 11 U.S.C. §547(b).

Therefore, we will reverse and remand to the district court for further proceedings consistent with this opinion.

HUTCHINSON, *Circuit Judge,* Dissenting.

I would affirm the order of the district court for the reasons set forth in the majority opinion of Judge Douglas Ginsburg for the District of Columbia Circuit in *Drabkin v. District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987).

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

Filed: July 13, 1989
FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 88-1788

HARRY P. BEGIER, JR., Trustee

v.

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE,

Appellant

Appeal from the United States District Court
For the Eastern District of Pennsylvania
(D. C. Civil No. 88-3529)

Argued January 31, 1989

Before HUTCHINSON, SCIRICA and
NYGAARD, *Circuit Judges*

ORDER AMENDING SLIP OPINION

IT IS HEREBY ORDERED that the slip opinion in the above case, filed June 30, 1989, be amended as follows:

at page 4, line 4, delete the words "Chapter 7" and insert the words "Chapter 11."

BY THE COURT,

/s/ Anthony J. Scirica
Circuit Judge

DATED: July 13, 1989

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF PENNSYLVANIA

IN RE:		
AMERICAN INTERNATIONAL AIRWAYS, INC.	)	BANKRUPTCY NO. 84-02379K
Debtor	)	
HARRY P. BEGIER, JR., TRUSTEE,	)	Civil Action 88-3529
Plaintiff,	)	
vs.	)	Philadelphia, Pennsylvania August 15, 1988
UNITED STATES OF AMERIGA INTERNAL REVENUE SERVICE,	)	9:30 a.m.
Defendant.	)	

TRANSCRIPT OF HEARING
BEFORE THE HONORABLE DONALD W. VAN ARTSDALEN
UNITED STATES DISTRICT JUDGE

APPEARENCES:

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Proceedings recorded by Electronic Sound Recording; transcript produced by transcription service.

• • •

Thank you, Your Honor.

THE COURT: All right. Thank you very much. Gentlemen, in this case, of course, we're primarily concerned with the interpretation of 11 USC, section 541 and – or 547 rather. The statute itself is plainly not very helpful and, therefore, there has been a great attempt by every one who has been faced with this to try to determine the legislative intent based upon the various statements that were made at the time and there have been different interpretations made from this.

The once case that both parties cite, that is certainly the most extensive on the interpretation of the statute, is *Drabkin versus District of Columbia*, reported in 824 Federal Reporter 2d, page 1102. It is a likely opinion and although the facts don't exactly fit the present case, they certainly – the discussion, of course, covers the issues that are involved here. Although, I find it difficult to reach any final conclusion as to just what the *Drabkin* court would have done were it faced with the situation presently here. It would seem to me that in – that there has to be established that the funds are in some way held in trust before the IRS can retain those particular funds which were paid to it during the period of time when it would be subject to – otherwise to an avoidance as a preference. I think it's clear under present law that the IRS does not hold any particular advantage over any other creditor, so far as avoidance of preferences are concerned.

The Government in this case takes the position that it is the burden – the burden is upon the debtor or the trustee, rather, to establish that they are entitled to recover the funds. In general, that would be correct, of course, but I think that all that the trustee has to show are the – so far as the issues of this case are concerned, is that the funds that were used did belong to the estate or were the property of the estate before they payment was made. And, clearly, that – that issue has been established. After that it seems to me that it then becomes the burden of the IRS to establish that in some way this was trust fund property and that, of course, is what the Government has tried to

contend. As I understand the Government's argument, although it may be overly simplified, it is because the legislative intent makes it clear that the Government could, or the IRS could have reasonable assumptions applied in determining whether or not there are trust funds set up, that the mere fact that there wasn't a payment made out of commingled funds establishes that it was trust property. I know that the Government has said no. They don't really take that extreme position but they say that once they establish that, then it would be up to the trustee to establish in some way that that would not be a reasonable assumption under the facts of the particular case by showing that the funds had in some way been segregated. IRS obviously has some difference from an ordinary creditor because the Internal Revenue statutes provide that the debtor or the trustee is required to, as are all taxpayers, to hold withholding taxes and employees – employees share of the FI – of the, I believe it's the FICA taxes, in trust. And, of course, at one time, I think previously, the U.S. Supreme Court *In RE Randall – United States versus Randall*, rather, 401 US 513, ruled that that provision took priority over the bankruptcy statute. That of course has since been changed by the new bankruptcy code and it's clear now that there is not an absolute priority but in doing that the legislate – legislative intent would appear to be that some advantage, such as the applying of reasonable assumptions, should be made. I'm not quite sure just what reasonable assumptions there would have to be shown, but I do not think that it would be sufficient for the IRS to reclaim money that was clearly from commingled funds simply on the basis that it would be reasonable to assume that since the payments were made that that was sufficient evidence that the funds had been held in trust.

There are cases that go both ways on this issue. It's a matter obviously that will at some point or other have to be addressed by the appellate courts. I read Judge Scholl's opinion. It is quite thorough and explains, I think, the situation quite well, although the real issues that are involved in this appeal do not require any great discussion or even understanding of where the particular funds came from or when they were made.

So far as the issues involved here, I think that it is simply a matter that there were commingled funds. That payments were made to the IRS out of these commingled funds within the statutory period for which an avoidance would ordinarily be proper. Certainly would be if it were an ordinary creditor. I'm going to affirm the decision of Judge Scholl on the basic issue. That is as to the decision which was in favor of the trustee in this case. I don't think that this requires as strict a tracing as what the IRS apparently concludes was intended by Judge Scholl's opinion. I do think, however, that it requires some evidence beyond – that that must be shown by the IRS, some evidence beyond that of merely having made the payment. Which, so far as I can see in this case is the only evidence that there is that there was a payment made out of commingled funds.

Now a stipulation of facts was originally entered into in this matter between the parties before the bankruptcy judge. Briefs, I gather, were prepared on the basis of that stipulation by the trustee. The Government then – or the IRS recognized that there were certain facts that weren't fully set forth in the – in the stipulation of facts or would have allowed different arguments to be made and they wanted to have a supplement to the stipulation of facts, which would not be agreed upon and, therefore, there was required to be a evidentiary hearing and further briefing. As a reason for that, the Bankruptcy Judge, Judge Scholl, placed the attorneys fees on the IRS on the basis of Bankruptcy Rule 9011, which is very similar to the Federal Rule of the Civil Procedure 11. I – certainly there's no evidence that the Government did, or the IRS did anything in this case but act in good faith. It was a matter that was simply overlooked, I gather, in preparing the original stipulation of facts. The only possible basis that I can see for imposing the attorney's fees on the – on the IRS would be that – that of Rule 9011, which if it is like Rule 11, certainly would – could not be properly interpreted as requiring or allowing the award of attorneys fees. So that it could only be based on some general equitable principles which the Bankruptcy Judge applied. I don't know of any law or case that says on general equitable principles the attorneys fees for any particular portion of a case

may be imposed upon the opposing – one party or the other. And, therefore, as to the imposition of the $375 attorney's fee, I am going to and I do reverse the decision of the Bankruptcy Judge. By doing that and because that matter is considered here on the merits, I don't think it's necessary to go into the reason for denying the motion for reconsideration, which Judge Scholl stated was filed late. It would appear that it was not filed late but that is not necessary to decide at this point. So I am affirming the Bankruptcy Court on its decision as to the avoidance issue and will reverse on the fee – attorney's fee charge of $375. All right. Thank you very much.

One further thing. As I say, there are cases on both sides on this matter. It seems to me it's a very close case and it's a matter of how, I suppose, one interprets what the – what Congress intended and that's always a very difficult and hazardous guess on the part of Courts. So that I think this is a case that might well be d always a very difficult and hazardous guess on the part of courts. So that I think this is a case that might well be decided by different judges in a different way and I can understand that. All right. Thank you very much.

MR. WINTERHALTER: Thank you, Your Honor.

MR. GLICK: Thank you, Your Honor.

CERTIFICATION

I, JoAnn Stott, certify that the foregoing is a correct transcript from the electronic sound recording of the proceedings in the above-entitled matter.

JO ANN STOTT Date

* * *

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re: AMERICAN INTERNATIONAL AIRWAYS, INC. Debtor	:	Chapter 11 Bankruptcy No. 84-02379K
HARRY P. BEGIER, JR., TRUSTEE Plaintiff	:	
v.	:	
UNITED STATES OF AMERICA, INTERNAL REVENUE SERVICE Defendant	:	Adversary No. 86-1076K

OPINION

A. INTRODUCTION AND PROCEDURAL HISTORY

The instant proceeding is an action in which the Trustee of a defunct commercial airline now a Chapter 11 Debtor seeks to avoid alleged preferential transfers by the Debtor of substantial sums (approaching $1 million) to the Internal Revenue Service (hereinafter referred to as "IRS"). Herein, we revisit a factual pattern which we addressed in a previous Opinion in this case reported at 70 B.R. 102 (Bankr. E.D.Pa. 1987) (referred to hereinafter as *"IRS Trust"*),[1] and legal issues which we addressed in an Opinion arising out of another proceeding to avoid an alleged preferential transfers to another party in this same case, reported at 68 B.R. 326 (Bankr. E.D.Pa. 1987) (referred to hereinafter as *"Krain"*).[2] We hold that the Trustee is entitled to avoid transfers in the sum of $700,410.33 out of transfers totaling $1,641,434.06.

The underlying Chapter 11 bankruptcy case was filed on July 19, 1984. In the early stages of the case, the Debtor

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1. We utilize this designation because we concluded therein that the IRS could successfully assert a trust as to funds segregated in an account established pursuant to 26 U.S.C. §7512.

2. This designation is taken from the name of the Defendant in that adversarial proceeding, Krain Outdoor Advertising, Inc.

attempted to remain in business as a debtor-in-possession. However, by September 19, 1984, the Plaintiff in this proceeding had been appointed as Trustee, and the case has thereafter progressed in a liquidation mode. *See In re American International Airways, Inc.*, 74 B.R. 691, 692-93 (Bankr. E.D.Pa. 1987).

The instant proceeding was commenced by the Trustee on September 18, 1987, seeking to recover funds transferred to the IRS in three separate transactions totalling $946,434.06. The Complaint was later amended to include a fourth transfer of $695,000.00, the sum ultimately ascertained to have been deposited into the trust fund account discussed in the *IRS Trust* Opinion.

On February 11, 1987, the IRS filed a Motion for Judgment on the Pleadings or, alternatively, for Summary Judgment in its favor as its initial response to the Complaint. However, the IRS shortly thereafter agreed to withdraw this motion, and, on May 19, 1987, we entered a Pre-trial Order scheduling a trial on August 6, 1987. On that date, the parties advised that they had intended to prepare a Stipulation of Facts and would thereafter file a supplemental Stipulation of Facts, all of which would constitute the record. Accordingly, on August 7, 1987, they filed their initial Stipulation of Facts, and, on September 1, 1987, we entered an Order providing that the supplemental Stipulation would be filed by September 11, 1987, and that briefing, to be completed by October 28, 1987, would follow.

However, in the midst of the briefing, on October 15, 1987, the IRS filed a Motion to Clarify or Grant Relief from the initial Stipulation of Facts, contending that it had erred in its agreement therein as to the Debtor's filing status. We granted that motion over the Trustee's objection in an Order of October 21, 1987, although we did require the IRS to pay $375.00 to the Trustee for causing him to spend time preparing a brief which relied upon the Stipulation as its factual basis. On October 21, 1987, we also entered a Second Pre-trial Order, scheduling a potential evidentiary hearing, if necessary in light of this modification of the Stipulation, on November 17, 1987.

The hearing was in fact conducted on November 17, 1987. The Trustee called George L. Miller, an accountant who was appointed as "financial management consultant" for the Trustee on July 29, 1985, as his sole witness. The IRS called Alan D. Zlatkin, a revenue officer in its collection division who had serviced the Debtor's account in the pertinent early 1984 period, as its sole witness. After the hearing, the Trustee requested an opportunity to obtain a copy of the transcript before preparing further briefs. Accordingly, we entered an Order of November 18, 1987, allowing the parties to submit their respective briefs at twenty-day intervals subsequent to completion of the transcript. The transcript was not completed until early January, 1988, extending the briefing through February 22, 1988.

In the course of the briefing, the Trustee discovered a letter of May 1, 1984, from Mr. Zlatkin to Bruce Edmondson, the Debtor's chief operating officer, and he moved to open the record to add it. By Stipulation of February 2, 1988, the letter was added to the record by agreement.

Although there were certain factual disputes which the parties believed to be material between them, resulting in the November 17, 1987, hearing, we do not believe that these factual disputes had any significant bearing on our ultimate disposition. Nevertheless, per the dictates of Bankruptcy Rule 7052 and Federal Rule of Civil Procedure 52(a), we are preparing our Opinion in the format of Findings of Fact, Conclusions of Law, and a Discussion.

B. FINDINGS OF FACT

1. On February 22, 1984, Mr. Zlatkin's office prepared a letter to Mr. Edmondson, informing him that, "effective for the month of March, 1984, . . . for the first quarter of 1984 by April 15, 1984," the Debtor was obliged to file monthly, as opposed to quarterly, returns for its Form 941 employment taxes, covering employees FICA and federal income tax withheld by the Debtor (referred to hereinafter as "withholding taxes"), and for its Form 720 excise taxes (referred to hereinafter as "excise taxes").

2. Although the letter was erroneously sent out prior to March 1, 1984, on the latter date it was properly hand-delivered to Mr. Edmondson by Mr. Zlatkin, with a notice also requiring the Debtor to "immediately" establish a separate bank account in which to make deposits of future amounts due for withholding and excise taxes as trustee for the IRS, pursuant to 26 U.S.C. §7512.

3. The Debtor wrote to the IRS on March 6, 1984, advising that it had that day established a trust fund account as directed in Industrial Valley Bank and Trust Co., at Account No. 802-304-2.

4. Although, according to Mr. Zlatkin, the Debtor was not required, per the terms of the letter, to begin filing monthly returns until April, 1984, the Debtor nevertheless proceeded to file returns for January and February, 1984, on March 15, 1984.

5. The Debtor did make certain deposits into the trust account through the end of April, 1984, after opening this account.

6. Withholding taxes must be paid to the IRS within three business days after the payroll from which the taxes are withheld, or a penalty is imposed upon the taxpayer-employer.

7. There is no statement in the record as to whether or when a penalty is imposed for late payment of excise taxes.

8. The penalty for late payment of withholding taxes is not assessed until the employer's returns are filed. However, unless the employer is granted an extension or some other dispensation, the penalty is assessed at the time of the filing of the return if the payment is not made in timely fashion.

9. The Debtor remitted the following payments in issue to the IRS:

a. April 30, 1984 – $695,000.00 from the trust fund account.

b. April 30, 1984 – $734,797.71 from one of the Debtor's general accounts.

c. June 22, 1984 – $200,000.00 from the same general account.

d. June 27, 1987 – $11,636.35 from the same general account.

10. The above payments were allocated, respectively, as follows:

a. Both April 30, 1984 payments (allocation not designated between them):

(1) $259,992.98, for full payment of January, 1984, withholding taxes;

(2) $228,781.00, for full payment of February, 1984, withholding taxes;

(3) $102,360.01, for full payment of February, 1984 excise taxes;

(4) $105,765.68, for part payment of March, 1984, withholding taxes;

(5) $203,000.33, for full payment of March, 1984, excise taxes;

(6) $300,000.00, for current April, 1984 withholding taxes; and

(7) $229,797.71, for current April, 1984, excise taxes.

b. June 22, 1984, payments – for first quarter, 1984, withholding taxes.

c. June 27, 1984, payment – for certain 1982 and 1983 taxes.

11. The trust account, having been established on March 6, 1984, to pay taxes collectible only after its existence, could not have been utilized as a depository for any taxes collectible earlier than March, 1984.

12. All withholding taxes due in January, 1984, and February, 1984, totalling $488,773.98, were collectible earlier than March, 1984; could not have been made out of trust funds; and hence cannot be allocated to the $695,000.00 payment.

13. The record does not contain facts sufficient to conclude that any of the other sums paid on April 30, 1984, necessarily would had to have been allocated from either of the two April 30, 1984, payments.

14. The parties stipulated that the Debtor was insolvent as of the date of all of the transfers and that the requirement of 11 U.S.C. §547(b)(5) was met as to all of the transfers.

C. CONCLUSIONS OF LAW

1. The $695,000.00 payment out of trust funds cannot be reached by the Trustee. However, no other funds paid to the IRS can be similarly classified as trust funds, and hence the Trustee can recover any other payments as preferential to the extent that he can prove that all of the elements of 11 U.S.C. §547(b) were present and that no defense pursuant to 11 U.S.C. §547(c) can be proven by the IRS as to these other payments.

2. A tax debt is "incurred," per §547(a)(4), when penalties are imposed, irrespective of when the returns for that tax are due. The returns for all taxes from January, 1984, and February, 1984, were due as of April 15, 1984, prior to the payments of April 30, 1984. Hence, there is no question that all of the tax obligations for January, 1984, and February, 1984, were "antecedent debts," pursuant to 11 U.S.C §547(b)(2).

3. All of the requirements of 11 U.S.C. §547(b) were therefore met as to the portion of the transfers of April 30, 1984, which were credited to any January, 1984, and February, 1984, taxes, as well as to the two subsequent June, 1984 transfers.

4. The IRS has not met its burden of proving that the April 30, 1984, payments made towards any January, 1984, and February 1984, tax obligations were made within forty-five (45) days of the date when the debts were incurred, per §547(a)(4), and certainly it cannot prove this as to either of the June, 1984, payments. Therefore, the IRS is not able to prove the element of former 11 U.S.C. §547(c)(2)(B), which is applicable to this case, i.e., that the payments were made not later than forty-five (45) days from when the debts were incurred.

5. However, assuming *arguendo* that it could have met its burden of proving the element of former §547(c)(2)(B), the IRS must additionally prove all of the other elements of §547(c)(2) to succeed in asserting this Code section as a defense. It has failed to prove that the Debtor made any of the payments in the ordinary course of the affairs between the parties or according to ordinary business terms, as required by former 11 U.S.C. §§547(c)(2)(C) and (c)(2)(D), respectively. Consequently, the IRS has not proven the existence of a §547(c)(2) defense as to any of the relevant transfers.

6. Therefore, except to the extent that it is able to argue that certain of the portions of the $695,000.00 trust fund payment could be allocated to taxes collectible prior to March, 1984, the IRS has no viable defenses to the Trustee's claims.

7. The IRS cannot argue that the January, 1984, and February, 1984, withholding taxes paid with the April 30, 1984, funds could possibly have been allocated to the trust fund payment, because those taxes were collectible prior to the establishment of the trust fund.

8. There is no evidence that any other taxes paid on April 30, 1984, could not be allocated to either of the two sources of the April 30, 1984, payments.

9. The IRS is empowered to allocate the remainder of the total April 30, 1984, payments, exclusive of the January, 1984, and February, 1984, withholding taxes (total = $1,429,797.71; remainder = $941,023.71) however it wishes. It is therefore entitled to allocate the $695,000.00 payment to any of the taxes paid in April except those on account of the January, 1984, and February, 1984, withholding taxes.

10. The trustee is therefore entitled to avoid the transfer of only that portion of the April 30, 1984, payments attributable to January, 1984, and February, 1984, withholding taxes, i.e., $488,773.98, plus the June, 1984 transfers, which totaled $211,636.35.

11. The Trustee is entitled to judgment in the amount of $700,410.33 against the IRS.

D. DISCUSSION

Our starting point is the observation that payments made by a debtor on tax obligations are subject to avoidance as preferential transfers, like any other transfers which meet the following criteria of 11 U.S.C. §547(b):

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made)—
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to receive more than such creditor would receive if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

No exception is contained in §547 for payments on taxes. Moreover, 11 U.S.C. §547(a)(4) states that, for purposes of §547, "a debt for a tax is incurred on the day when such tax is last payable without penalty, including any extention." Obviously, if Congress meant to exempt tax payments for the scope of §547,

there would have been no reason to include any provision such as §547(a)(4) in the code. Collier so indicates, when it states that this language *replaced* earlier language which would have exempted tax claims from the scope of §547. *See* 4 COLLIER ON BANKRUPTCY, ¶547.02[4], at 547-16 (15th ed. 1987). The IRS apparently does not dispute this point, as its Supplemental (and final) Memorandum of Law cites with approval to two cases in which payments to the IRS were deemed subject to 11 U.S.C. §547, *In re Cleveland Graphic Reproductions, Inc.*, 78 B.R. 819 (Bankr. N.D.Ohio 1987); and *In re Morris*, 53 B.R. 190 (Bankr. D.Ore. 1985). *See also, e.g., Drabkin v. District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987); *United States v. Air Florida, Inc.*, 56 B.R. 732 (S.D.Fla. 1985); *In re R & T Roofing Structures & Commercial Framing, Inc.*, 42 B.R. 980, 913-16 (Bankr. D.Nev. 1984); *Cf. In re Miller's Auto Supplies, Inc.*, 75 B.R. 676 (Bankr. E.D.Pa. 1987) (payments on state taxes avoidable as preferential transfers).

The second issue is whether payments for taxes are removed from the property of the Debtor's estate and hence exempt from characterization as preferential transfers because such payments are supposed to be held as trust funds by debtors. We articulated our limited application of this theory in the *IRS Trust* Opinion in this very case, 760 B.R. at 105. *See also In re Rimmer Corp.*, 80 B.R. 337, 338-39 (Bankr. E.D.Pa. 1987); and *Miller, supra*. There, we concluded that only where a tax trust fund is actually etablished by the debtor and the taxing authority is able to trace funds segregated by the debtor in a trust account established for the purpose of paying the taxes in question would we conclude that such funds are not property of the debtor's estate.

We acknowledge several authorities holding to the contrary, i.e., that the mere requirement that the debtor establish a trust account for tax payments exempts any payment for taxes from the scope of property of the estate. *In re Rodriguez*, 50 B.R. 576 (Bankr. E.D.N.Y. 1985); and *In re Razorback Ready-Mix Concrete Co*, 45 B.R. 917 (Bankr. E.D.Ark. 1984). However, the first Court of Appeals addressing the issue in *Drabkin, supra*, not only concurred with our reasoning, but cited our *IRS*

Trust Opinion on this issue with approval. 824 F.2d at 1110 n. 27. Other courts have concurred with our reasoning. *See, e.g., Air Florida, supra; In re Olympic Foundry Co.*, 63 B.R. 324, (Bankr. W.D.Wash. 1986); and *In re Major Dynamics, Inc.*, 59 B.R. 697 (Bankr. S.D.Cal. 1986). We reiterate our belief that the application of the trust fund theory must be limited as we indicated in our prior decisions.

This observation resolves the issue as to whether the June, 1984, transfers were preferential payments. The only argument made by the IRS as to why these payments should not be deemed preferential is the broad reading of the trust theory espoused by *Rodriguez, supra,* and *Razorback, supra,* and rejected by us. Therefore, the Trustee is clearly entitled to judgment in his favor as to the $211,636.35 paid to the IRS by the Debtor in June, 1984.

The April 30, 1984, transfers are, of course, far more difficult to analyze. On one hand, the Trustee argues that the entire amount of $734,797.71 remitted from the Debtor's general account represented a preferential transfer. The IRS, meanwhile, contends that it can allocate the entire $695,000.00 trust fund to the January and February, 1984, taxes and that, viewing the $734,797.71 as allocated to only March and April, 1984, taxes, none of the payments from the Debtor's general account were preferential. The first building block of the IRS's argument is its contention that none of the Debtor's first quarter, 1984, taxes were incurred until its returns were due on April 15, 1984, and that, since the returns for the April, 1984, taxes were not yet due, the April, 1984, tax obligations were not antecedent debts, per 11 U.S.C. §547(b)(2). The second building block is its contention that 11 U.S.C. §547(c)(2), the applicable version of which provided as follows,[3] establishes a defense as to all of the Debtor's tax payments for the first quarter of 1984:

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3. The pre-1984 version of the Code applies to this case because it was initiated prior to the effective date of the 1984 amendments. *See Krain, supra,* 68 B.R. at 327-28 & n. 2.

(c) The trustee may not avoid under this section a transfer—

. . .

(2) to the extent that such transfer was—

(A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made not later than 45 days after such debt was incurred;

(C) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(D) made according to ordinary business terms; . . .

The first question which must be resolved is when a tax debt is deemed to be "incurred." As we indicated at page 12 *supra*, §547(a)(4) gives explicit guidance on this point, stating that it is incurred when it is "last payable without penalty, including any extension." The parties dispute the meaning of this seemingly simple language when applied to federal withholding taxes. The Debtor contends that it means that as soon as a penalty is imposed, which occurs if payment is not made within three business days of the taxpayer's payroll, the tax debt is "incurred." The IRS, focusing on the term "payable," contends that it means that a tax debt is not incurred until the returns from that tax are due.

Assuming *arguendo* that the IRS is correct in its contention that the date that returns are filed is significant leads to a further dispute as to whether the letter of February 22, 1984, required the Debtor to begin making monthly returns in March, 1984, or April, 1984. The IRS contends that the effective date of the letter was April, 1984, and hence, despite the Debtor's alleged misinterpretation which caused it to make the filing for January and February on March 15, 1984, the returns for the first quarter of 1984 were not in fact due until April 15, 1984. The

IRS then argues that none of the taxes for the first quarter of 1984 were "incurred" until April 15, 1984, a date preceding the Debtor's payment by only fifteen (15) days. Thus, the IRS concludes that it met the requirement of former §547(c)(2)(B).[4]

Our research reveals that interpretation of §547(a)(4) is almost non-existent. Collier accurately states that "Congress provided little explanation for this provision."[5] COLLIER, *supra*. The *only* case which our exhaustive research had indicated has ever been purported to interpret this provision is *Drabkin*, *supra*, where the court states that, if the debtor's tax payment "had been made within 45 days after the penalty period began, then the Trustee could not recover the payment." 824 F.2d at 1115.

This statement by the court in *Drabkin* supports the Trustee's interpretation, as does, we believe, the clear language of §547(a)(4), which references the imposition of penalty as the significant event. The fact that the penalty, though imposed, is not assessed until later, appears irrelevant. It is the *imposition of the penalty* which the statute indicates is significant.

Finally, the interpretation of the Trustee is consistent with the "classic statement" of when a debt is incurred for purposes of §547(c)(2) in *In re Emerald Oil Co.*, 695 F.2d 833, 837 (5th Cir. 1983), i.e., on the date that the debtor becomes liable for a debt, not the date on which an invoice is prepared or on which the debtor is billed. *See Krain*, *supra*, 68 B.R. at 332; and *In re Art Shirt, Ltd.*, 68 B.R. 316, 324 (Bankr. E.D.Pa. 1986) (both cases cite numerous cases following *Emerald*). The date of imposition of the penalty appears to us to be comparable to the date that liability is imposed. The date that the return is due

4. The IRS appears to erroneously argue that, if it meets the requirement of §547(c)(2)(B), it has established a §547(c)(2) defense. This is, of course, not so, because the four requirements of §547(c)(2) are set forth in the conjunctive, not the disjunctive. *See* page 20 *infra*.

5. Actually, Congress appears to have given equivocal explanations of this provision. *See* page 17 & 18 n. 6 *infra*.

appears comparable to the preparation of an invoice of amounts due for an already-imposed liability.[6]

We therefore conclude that, for purposes of §547(a)(4), tax debts are incurred as soon as penalties are imposed. It is undisputed that penalties for failing to pay withholding taxes are imposed if payments for the taxes are not remitted within three business days from the date that the taxpayer makes its payroll. It is therefore clear to us that the January and February, 1984, withholding taxes were incurred prior to the opening of the IRS trust account as a depository for payments on of future tax liabilities of the Debtor on March 6, 1984.

Furthermore, the January and February, 1984, withholding taxes cannot be allocated to the trust account payment. As 26 U.S.C. §7512(b) makes clear, is only tax liabilities "which become collectible after delivery of . . . notice" to establish a trust fund which are to be deposited into such an account. *See United States v. Stevenson*, 540 F.Supp. 93, 95 (D.Del. 1982)

6. The IRS, in its initial brief and at argument after the trial on November 17, 1987, asserts authority for its interpretation in the reports to the houses of Congress on the compromises effected in the enactment of the final bill relating to §547(c)(2)(B) which stated that "the 45-day period referred to in [Section] 547(c)(2)(B) is to begin running in the case of taxes from the last due date, including extensions, of the return to which the tax payment is made." 124 CONG. REC. H 11114 (daily ed. Sept. 28, 1978); S 17431 (daily ed. Oct. 6, 1978). However, the earlier House Report, addressing apparently the identical language, states that "if a payment is made later than the last day which the tax may be paid without penalty, then the payment may constitute a preference." H. REP. No. 595, 95th CONG., 1st Sess. 373 (1977).

This legislative history, relating specifically to §547(c)(2)(B), is therefore ambiguous and inconclusive in assisting us to interpret §547(a)(4). we are certainly not prepared to read a reference ot the date of the filing of a tax return into §547(a)(4) when the only reference in the statute itself is to whether a penalty has been incurred.

In any event, irrespective of the legislative history, the statute in issue clearly makes reference to the date that a tax is payable without penalty rather than date of the filing of the return. Where a statute is plain on its face, it must be interpreted as it reads without resort to legislative history *See, e.g., American Tobacco Co. v. Patterson*, 456 U.S. 63, 68 (1982); *Caminetti v. United States*, 242 U.S. 472, 485, 490 (1917); and *United States v. Pennsylvania Environmental Hearing Bd.*, 584 F.2d 1273, 1281 n. 26 (3d Cir. 1978).

("the requirements of section 7512 are directed toward funds withheld *subsequent to* a failure to withhold and a notice delivered in hand") (emphasis in original). The testimony of Mr. Zlatkin clearly establishes that the notice requiring establishment of the trust fund was not delivered to Mr. Edmondson until March 1, 1984, irrespective of the earlier date appearing on it. The trust account was not opened until March 6, 1984. The January and February, 1984, withhholding taxes perforce must have related to taxes incurred *before* the delivery of the notice or the establishment of the fund rather than *subsequent* thereto. Therefore, the deposits in the fund cannot be allocated to the January and February, 1984, withholding taxes paid out of the April 30, 1984, remittances.

We are uncertain as to when the February, 1984, excise taxes were incured, or when any of the March, 1984, and April, 1984, taxes were incurred. We therefore cannot be positive of the allocation of any portion of the $734,797.21 non-trust-fund payment as to any taxes except the January and February, 1984, withholding taxes, in the total sum of $488,773.98. As we indicate in our discussion at pages 24-25 *infra*, the IRS is empowered to allocate the balance of the payments however it chooses, restricting the Trustee to the recovery of $488,733.98 from the April 30, 1984, transfers.

We now return to analysis of 11 U.S.C. §§547(b) and 547(c)(2) of the Code to determine whether our conclusion that the payment of the January and February, 1984, withholding taxes only was preferential is consistent therewith. Admittedly, the only element of §547(b) concerning which the IRS contended that the Trustee had not met his burden, as to any of the non-trust-fund transfers, was §547(b)(2). Clearly, the January and February, 1984, withholding taxes were "antecedent debts" as of April 30, 1984. The only contest on this point was as to the payments on the April, 1984, taxes, which we conclude cannot be avoided in any event.

The final point of analysis is consideration of whether the IRS can defend against the transfer of the payments of January and February, 1984, withholding taxes on the basis of §547(c)(2). First, as is emphasized in *Cleveland Graphic, supra*, 78 B.R. at

822; and *In re Magic Circle Energy Corp.*, 64 B.R. 269, 272 (Bankr. W.D.Okla. 1986), the requirements of §547(c) are set forth in the conjunctive. Therefore, in cases involving the pre-1984-amendment version of §547(c)(2), all four conditions set forth therein must be satisfied to successfully invoke this defense. *See In Re Craig Oil Co.*, 785 F.2d 1563, 1564-65 (11th Cir. 1986); and *In re Naudain*, 32 B.R. 871, 874 (Bankr. E.D.Pa. 1983).

Secondly, the burden of proving all of these elements is squarely upon the IRS. *See In re Production Steel, Inc.*, 54 B.R. 417, 422 (Bankr. M.D.Tenn. 1985); and *In re Ewald Bros., Inc.*, 45 B.R. 52, 56 (Bankr. D.Minn. 1984). *See generally In re Energy Cooperative, Inc.*, 832 F.2d 997, 1004 (7th Cir. 1987); and *Magic Circle, supra*, 64 B.R. at 272.

While the IRS undoubtedly has established the element of §547(c)(2)(A) as to all of the transfers in issue, there is considerable question as to whether it has met its burden as to any of the three remaining elements as to the Debtor's payments of April 30, 1984, toward January and February, 1984, withholding taxes.

The first remaining element, set forth in former §547(c)(2)(B), requires the IRS to establish that payment was made not later than 45 days after the debt was incurred. Since the debts for withholding taxes due in January and February, 1984, were incurred no later than the earliest days of March, 1984, *see* discussion at pages 15-18 *supra*, it is clear that payments remitted on April 30, 1984, *were* made later than 45 days after these particular debts were incurred. The failure to prove this element in itself appears to be fatal to the IRS's §547(c)(2) defense.

However, the IRS has not met its burden of proving the additional elements of §§547(c)(2)(C) or (D), either. As the court in *In re Bourgeous*, 58 B.R. 657, 658 (Bankr. W.D.La. 1986), emphasizes, a creditor defending a preferential transfer claim on the basis of §547(c)(2) must prove that the payment was "in the ordinary course of business of the debtor *and* the transferee" *and* "according to ordinary business terms."As several courts have articulated, these are two discrete tests, the one pertaining

to the "subjective" course of dealings between these particular parties, and the other pertaining to the "objective" normative course of business of similarly-situated parties. *See, e.g., Windsor Communications Group v. Freedom Greeting Card Co.,* 63 B.R. 770, 774-75 (E.D.Pa. 1986), *rev'd,* 815 F.2d 697 (3d Cir. 1987); *In re Steel Improvement Co.,* 79 B.R. 681, 683-85 (Bankr. E.D.Mich. 1987); *Magic Circle, supra,* 64 B.R. at 272-75; and *Production Steel, supra,* 54 B.R. at 422-24.

The IRS presented no evidence of the particular course of dealing between it and the Debtor such as would meet its burden of proving that these transfers were within the "subjective" ordinary course of their past dealings. There were generalized insinuations by Mr. Zlatkin that the Debtor was not a diligent taxpayer prior to the transfers in issue. However, we believe that the burden was upon the IRS to specifically qualify and quantify the parties' past course of dealings relevant to the transfers in issue and show that these transfers were consistent therewith if it wished to satisfy §547(c)(2)(C). This, we believe it totally failed to do.

Finally, to succeed in a §547(c)(2) defense, the IRS was obliged to establish that the Debtor's tax payment record was objectively that of a normal, similarly-situated taxpayer.We agree with the IRS's citation of *Cleveland Graphic, supra,* and *Morris, supra,* to make the point that payment of taxes in due course should not be considered other than objectively "ordinary," irrespective of a Debtor's poor past record of making such payments. However, here, the relevant issue is the converse: can a debtor ever justify a failure to pay taxes in timely fashion as "ordinary," even if making untimely payments was its normal past course of conduct? *Cf. Craig, supra,* 785 F.2d at 1567-68 (lateness is of particular relevance in ascertaining whether payment terms were ordinary). With respect to the payments remitted on April 30, 1984, the "ordinariness" decreases as the period for which taxes are paid becomes more distant. Hence, it is difficult to justify the timeliness, on April 30, 1984, of payments due without penalty three days after the dates that payrolls were made in January and February, 1984. Furthermore, the action of the IRS in invoking 26 U.S.C. §7512

was an extraordinary remedy. Its mere use here implies that the Debtor failed, in substantial part, to meet payment terms which the IRS deemed objectively ordinary.

We therefore conclude that, at least as to the January and February, 1984, withholding tax payments, the IRS has failed to meet its burden of establishing most of the requisite elements of §547(c)(2). The payments for these tax liabilities may therefore be avoided by the Trustee.

However, having determined that the IRS cannot allocate the January and February, 1984, withholding tax payments to the trust fund, we further hold that it *can* allocate the remainder of the payments between those received from the trust fund and those received from the Debtor's general account however it wishes and thus eliminate the prospect of avoidance of any additional preferential transfers.

We agree with the Trustee's argument that the payments made by the Debtor were voluntary, and hence not within the scope of the decision of the Third Circuit Court of Appeals in *In re Ribs-R-Us, Inc.,* 828 F.2d 199 (3d Cir. 1987). (IRS can allocate payments on pre-petition priority tax liabilities because such payments are involuntary.)

However, even as to voluntary payments, the creditor has the right to allocate payments as it sees fit if the debtor abdicates its right to do so. *See Pristas v. Landaus of Plymouth, Inc.,* 742 F.2d 797, 801 (3d Cir. 1984); *In re Comer,* 716 F.2d 168, 175 (3d Cir. 1983); and *Page v. Wilson,* 150 Pa.Super. 427, 433, 28 A.2d 706, 709 (1942). Thus, the IRS should have the right, in the Debtor's failure to do so, to designate allocation of the voluntary payments made by the Debtor to it on April 30, 1984. *See, e.g., National Bank of Commonwealth v. Mechanics' National Bank,* 94 U.S. 437, 439 (1877); and *Wood v. United States,* 808 F.2d 411, 416 (5th Cir. 1987).

The IRS may therefore proceed to allocate the balance of the proceeds of the $695,000.00 trust-fund payments to whatever obligation it chooses, except for the January and February, 1984, withholding tax payments, to which trust fund payments plainly could not be allocated. This right of allocation extends to even the February, 1984, excise taxes, because the Trustee,

although imposed with the burden of establishing all elements of the preferential transfers in issue, has failed to establish when the debt for such taxes was incurred, pursuant to §§547(b)(2) and (a)(4). The entire $695,000.00 trust fund could have been allocated to the February, 1984, excise taxes; the March, 1984, taxes; and almost all of the April, 1984, withholding taxes. The Trustee has also not proven that at least some of the April, 1984, withholding taxes were not payable without penalty as of April 30, 1984, and consequently has not proven that some of these taxes were incurred as of that date. Therefore, the Trustee has not established that the IRS may not allocate any payments except the $488,773.98 from the January and February, 1984, withholding taxes to the payments from the trust fund.

The Trustee is therefore entitled to set aside the preferential transfer of $488,773.98 from the April 30, 1984, payments, and no more, in addition to the $211,636.35 transferred in June, 1984. Therefore, we are entering judgment in favor of the Trustee in the amount of the sum of these figures, $700,410.33, in our accompanying Order.

DAVID A SCHOLL
UNITED STATES BANKRUPTCY JUDGE
3722 United States Court House
Philadelphia, PA 19106-1763

Dated at Philadelphia, PA,
this 9th day of March, 1988.

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re:	:	Chapter 11
AMERICAN INTERNATIONAL AIRWAYS, INC.	:	
Debtor	:	Bankruptcy No. 84-02379K
HARRY P. BEGIER, JR., TRUSTEE	:	
Plaintiff	:	
v.	:	
UNITED STATES OF AMERICA, INTERNAL REVENUE SERVICE	:	
Defendant	:	Adversary No. 86-1076K

ORDER

AND NOW, this 9th day of March, 1988, upon consideration of the fact stipulations of the parties, evidence adduced at trial of this matter on November 17, 1987, and the various Memoranda submitted by the parties, it is hereby

ORDERED AND DECREED that judgment is entered in favor of the Trustee and Plaintiff, HARRY P. BEGIER, JR., and against the Defendant, UNITED STATES OF AMERICA, INTERNAL REVENUE SERVICE, in the amount of $700,410.33.

DAVID A. SCHOLL
UNITED STATES BANKRUPTCY JUDGE
3722 United States Court House
Philadelphia, PA 19106-1763

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IN THE UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re:	:	Chapter 11
AMERICAN INTERNATIONAL AIRWAYS, INC.	:	
Debtor.	:	Bankruptcy No. 84-02379K
HARRY P. BEGIER, TRUSTEE	:	
Plaintiff,	:	
v.	:	
UNITED STATES OF AMERICA; INTERNAL REVENUE SERVICE,	:	
Defendants.	:	Adversary No. 86-1076

STIPULATION OF FACTS

The plaintiff, Harry P. Begier, Trustee, and the defendants, the United States of America and its Internal Revenue Service, by and through counsel, do hereby stipulate and agree as follows:

1. On April 30, 1984, the Internal Revenue Service received a payment of $1,429,797.71 (hereinafter referred to a "Payment 1") which consisted of a $734,797.71 check drawn from a checking account of the debtor at Industrial Valley Bank ("IVB") (Account No. 0-898-897-8) and a $695,000 Treasurer's Check from IVB, the source of which was funds drawn from another checking account at IVB, Account No. 0-802-304-2. The Court previously ruled on February 20, 1987, that the debtor's Account No. 0-802-304-2 at IVB was an account established pursuant to 26 U.S.C., Section 7512 which was a designated account with the debtor as trustee for the United States and into which the debtor deposited unpaid Federal excise and withholding taxes so that monies contained in such account were not part of the bankruptcy estate.

2. Pursuant to an agreement entered into by the Internal Revenue Service and the Debtor, Payment 1 was applied as follows:

a. $259,992.98 to the debtor's Form 941 employment taxes (FICA and withholding taxes) for January, 1984;

b. $228,781 to the debtor's Form 941 taxes for February, 1984;

c. $105,765.68 to the debtor's Form 941 taxes for March, 1984;

d. $300,000 to the debtor's Form 941 taxes for April 1984;

e. $229,797.71 to the debtor's Form 720 taxes (excise taxes) for April, 1984;

f. $102,360.01 to the debtor's Form 720 taxes for February, 1984; and

g. $203,000.33 to the debtor's Form 720 taxes for March, 1984. (This sum was misapplied to Form 720 taxes for the 3rd *quarter* of 1984 rather than the 3rd *month* and will be applied correctly with the Court's permission).

3. On June 22, 1984, the Internal Revenue Service received a payment of $200,000 (hereinafter referred to as "Payment 2") which consisted entirely of a $200,000 check drawn from the debtor's IVB checking account no. 0-898-897-8.

4. Pursuant to a designation made by the debtor, Payment 2 was applied in its entirety to the debtor's Form 941 taxes for the 1st quarter of 1984.

5. On June 27, 1987, the Internal Revenue Service received a payment of $11,636.35 (hereinafter referred to as

Payment 3) which consisted entirely of a $11,636.35 check drawn from the debtor's IVB checking account no. 0-898-897-8.

6. Pursuant to a designation made by the debtor, $11,182.87 of Payment 3 was applied to the debtor's Form 940 taxes (FUTA taxes) for 1983 and the remaining $453.48 of Payment 3 was applied to the debtor's Form 11 taxes for July, 1982.

7. The debtor was a monthly filer of Form 941 and Form 720 tax returns beginning no later than April, 1984, and, pursuant to law, was required to make weekly deposits of Form 941 taxes.

8. The debtor was insolvent on 4/30/84, 6/22/84 and 6/27/84.

9. It is stipulated for the purposes of this matter that the requirements of 11 U.S.C. Section 547(b)(5) are met.

Dated: Aug. 6, 1987

Respectfully submitted,

FOR THE TRUSTEE:

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Court Order October 21, 1987

No. 89-393

In the Supreme Court of the United States

OCTOBER TERM, 1989

HARRY P. BEGIER, JR., ETC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether a debtor's pre-petition payment of its trust fund tax obligations can be avoided as a preference under Section 547 of the Bankruptcy Code.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

In the Supreme Court of the United States

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v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A2-A20) is reported at 878 F.2d 762. The oral opinion of the district court (Pet. App. A22-A26) is unreported. The opinion of the bankruptcy court (Pet. App. A27-A44) is reported at 83 Bankr. 324.

JURISDICTION

The judgment of the court of appeals was entered on June 30, 1989. A petition for rehearing was denied on July 28, 1989 (Pet. App. A1). The petition for a writ of certiorari was filed on September 11, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This case involves payments of trust fund taxes made to the government by a corporate debtor during the 90-day period before the debtor petitioned for relief in bankruptcy. Section 547 of the Bankruptcy Code (11 U.S.C.) allows the bankruptcy trustee to recover as a preference certain payments made out of the property of the debtor during this 90-day period. Trust fund taxes are those

taxes, such as transportation excise taxes and employees' federal income and social security taxes, that third parties are required to withhold or collect from others on behalf of the United States. See 26 U.S.C. 3102, 3402 and 4291. The Internal Revenue Code provides that these amounts collected by third parties are to be "held * * * in trust" for the United States and later paid over to the government. 26 U.S.C. 7501.

1. Petitioner is the trustee in bankruptcy of American International Airways, Inc., a commercial airline that formerly provided passenger and air cargo service in the eastern and midwestern United States (see Pet. 4). By the spring of 1984, American International had become delinquent in remitting to the United States the social security and income taxes that it had withheld from the wages of its employees, as well as the excise taxes that it had collected from its passengers. On March 1, 1984, the Internal Revenue Service (IRS) notified the company of its delinquency and required it thereafter to file monthly rather than quarterly returns of its employment and excise taxes. The IRS also required American International to establish a separate bank account for the deposit of these trust fund taxes collected from employees and passengers. Pet. App. A4, A29-A30.

Shortly after receiving this notification, American International opened a separate bank account into which it deposited *some*, but not all, of the excise and employment taxes that it held in trust for the government. On April 30, 1984, American International paid the IRS $695,000 from its separate trust account and $734,798 from one of its general operating accounts. The April payments were followed by two other payments from that general account in June, totalling $211,636. By agreement with the IRS, the company allocated the June 27 payment of $11,636 to its 1982 and 1983 excise taxes and allocated the other payments to specific withheld social security, income, and excise taxes due between January and April, 1984. Pet. App. A4, A30-A31, A47-A48.

On July 24, 1984, American International filed a petition for relief under Chapter 11 of the Bankruptcy Code and attempted to operate as a debtor-in-possession for the next three months. After this attempt proved futile, the bankruptcy court appointed petitioner as the company's trustee and began liquidation proceedings. Following his appointment, petitioner commenced an adversary proceeding to recover the $1,641,434 in withholding and excise taxes that the company had paid to the IRS in April and June 1984. Petitioner contended that these funds were recoverable as a voidable preference under Section 547 of the Bankruptcy Code because they were transferred to a creditor less than 90 days before the bankruptcy petition was filed. Pet. App. A4, A27-A28.

2. The bankruptcy court permitted the trustee to recover a portion of the funds in queston (Pet. App. A27-A44). It held that the $695,000 payment made by the company from its trust account was a nonavoidable transfer of funds held in trust for the government, and therefore it did not allow the trustee to recover those funds (*id.* at A32). The court refused, however, to view the payment of the trust fund taxes made from the general account as a transfer of funds held in trust for the government, and therefore it allowed the trustee to recover most of the payments made from that general account (*id.* at A32-A44).[1] Relying on its analysis of the issue in a previous adversary proceeding in this case, the court concluded that funds could be excepted from characterization as preferential transfers on the ground that they were being held by the debtor in trust for the government "only where a tax trust fund is actually established by the debtor and the taxing authority is able to trace funds segregated by the debtor in a trust account estab-

[1] The court held that $246,024 of the amount paid out of the general account was not a voidable preference because it was paid for taxes due less than 45 days before the payment and therefore constituted a payment in the "ordinary course of business" that is not voidable. Pet. App. A43-A44. See 11 U.S.C. 547(c)(2).

lished for the purpose of paying the taxes in question" (*id.* at A35).[2]

The government appealed the bankruptcy court's holding that a debtor's payment of its trust fund obligations could be considered the payment of funds held in trust for the government only if the payment came from a segregated account. The district court affirmed in a decision issued from the bench (Pet. App. A22-A26). The court stated that this is "a very close case" (*id.* at A26), but concluded that the bankruptcy court correctly held that the payments from the general account should not be treated as having been made out of a trust fund. While the court expressed doubt that the bankruptcy court had required "as strict a tracing as what the IRS apparently" believed, the district court concluded that the IRS must show "some evidence beyond that of merely having made the payment" in order to establish that payments from commingled funds were actually payments of funds held in trust (*id.* at A25).

3. A divided court of appeals reversed (Pet. App. A2-A20). After reviewing the legislative history of Section 547, the court concluded that Congress regarded "the act of payment of withholding taxes [as] identif[ying] those taxes as funds held in trust" (Pet. App. A16). The court drew a distinction between preference actions brought by a bankruptcy trustee to recover pre-bankruptcy payments —the context of this case—and efforts by the IRS to recover trust funds from the bankruptcy estate. The court noted that, in the latter context, Congress sought to relax the strict tracing required by lower court interpretations of this Court's decision in *United States* v. *Randall*, 401 U.S. 513 (1971), and established the rule that the IRS

[2] In the prior proceeding, the bankruptcy court had authorized the trustee to surrender funds remaining in the special trust account to the IRS. In so doing, the court had stated that a creditor successfully claiming specific funds is "obliged to make a strong showing of not only the creation of a trust, but also the tracing of the specific funds against which a trust is allegedly imposed in the possession of the debtor and/or trustee." *In re American International Airways, Inc.*, 70 Bankr. 102, 105 (Bankr. E.D. Pa. 1987).

can use "reasonable assumptions" to trace funds in the bankruptcy estate to withheld taxes (Pet. App. A10-A11). When the debtor pays the taxes before bankruptcy, however, the court ruled that the taxing authority need not rely on reasonable assumptions to trace the payments back to the funds withheld by the employer. Rather, the court held that the legislative history demonstrates Congress's intent that monies paid by the debtor for withholding taxes should be regarded as the payment of trust funds and therefore not a preference (*id.* at A13-A19). The court concluded that Congress provided that "the debtor's pre-petition payments on account of its tax withholding obligations are held to be a special fund in trust for the IRS for the government under I.R.C. § 7501 and are not preferential transfers of the debtor's property under 11 U.S.C. § 547(b)" (*id.* at A20).

The court of appeals acknowledged that its holding conflicts with *Drabkin* v. *District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987), which it characterized as "squarely address[ing]" the same question presented here. The court stated that it found "the *Drabkin* dissent convincing" (Pet. App. A13), explaining that the majority in *Drabkin* had misinterpreted the legislative history of Section 547 and had failed to distinguish between a debtor's pre-petition payment of withheld taxes and a post-petition action by the IRS to recover withheld taxes in possession of the estate (see Pet. App. A18-A19). Judge Hutchinson dissented for the reasons set forth by the majority in *Drabkin* (*id.* at A20).

DISCUSSION

The decision below correctly holds that the pre-petition payments of trust fund taxes made by the debtor in this case were not transfers of "property of the debtor" and hence are not subject to recovery as a preference under Section 547 of the Bankruptcy Code. We agree with petitioner, however, that the decision below conflicts with *Drabkin* v. *District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987). Because this conflict involves a recurring issue of considerable importance to bankruptcy administra-

tion, we do not oppose the granting of certiorari in this case.

1. Section 7501 of the Internal Revenue Code (26 U.S.C.) provides that certain taxes are to be collected by third parties and "held to be a special fund in trust for the United States" until they are paid over to the government. Section 547 of the Bankruptcy Code (11 U.S.C.), as applicable to this case, allows a trustee to avoid as a preference certain transfers "of property of the debtor" made within 90 days before the debtor files a petition in bankruptcy.[3] The Bankruptcy Code does not explicitly define the phrase "property of the debtor," and therefore its terms alone do not conclusively establish whether amounts paid to satisfy the debtor's trust fund tax liability should be regarded as "property of the debtor," notwithstanding the command of 26 U.S.C. 7501 that such funds are held in trust for the government. Nothing in the statute, however, supports the bankruptcy court's conclusion here (see Pet. App. A35) that such payments will not be viewed as having been made out of the trust fund unless the funds have been segregated in a special account established for the purpose of keeping the withheld taxes.

To the contrary, the legislative history of Section 547 clearly demonstrates that Congress intended that pre-petition payments of trust fund tax liabilities would not be voidable as a preference even if they were made out of non-segregated funds, as in this case. The House Report states (H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1978)):

> A payment of withholding taxes constitutes a payment of money held in trust under Internal Revenue Code § 7501(a), and thus will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payments.

[3] Section 547 was amended in 1984, but the amendments do not bear on the issue presented here. The 1984 amendments, however, did change the phrase in question from "property of the debtor" to "an interest of the debtor in property." Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, Tit. III, § 462(b)(1), 98 Stat. 378.

As Judge Ruth Ginsburg stated in her dissent in *Drabkin* v. *District of Columbia*, 824 F.2d at 1118, this passage clearly manifests the view that, 'if the debtor is able to make the payment, the taxes 'have been properly held for payment,' which places the trust beneficiary in a class separate from other creditors and thus removes this payment from the category of preferences voidable by the trustee." See also *Razorback Ready-Mix Concrete Co.* v. *United States*, 45 Bankr. 917, 922 (Bankr. E.D. Ark. 1984); *Pereira* v. *United States (In re Rodriguez)*, 50 Bankr. 576, 580-581 (Bankr. E.D.N.Y. 1985). As the court below recognized (Pet. App. A18), this rule that pre-petition payments of trust fund taxes are not a preference "reflects a proper consideration of the distinct nature of withholding taxes."

Moreover, even in situations where the amounts in question have not been denominated by the debtor as payments of trust fund taxes, Congress has indicated that segregation in a special account is not necessary for identifying particular funds as being held in trust for the government. Section 541(d) of the Bankruptcy Code excludes from the definition of "property of the estate" that property in which the debtor holds "only legal title and not an equitable interest." Thus, property held by the debtor in trust does not become part of the bankruptcy estate, and it may be procured by the equitable owner even after the bankruptcy petition has been filed. This principle is fully applicable to withheld taxes being held in trust for the government. See 124 Cong. Rec. 32417 (1978) (statement of Rep. Edwards).

Prior to the enactment of the Bankruptcy Code in 1978, the courts generally had imposed upon the IRS a very strict burden to trace withheld taxes into the debtor's general funds in order to claim that certain amounts should be excluded from the bankruptcy estate as funds held in trust for the United States. See, *e.g.*, *In re Ken-*

nedy & Cohen, Inc., 612 F.2d 963 (5th Cir.), cert. denied, 449 U.S. 833 (1980); *In re Shakesteers Coffee Shops*, 546 F.2d 821 (9th Cir. 1976). This strict tracing requirement was derived from this Court's decision in *United States* v. *Randall*, 401 U.S. 513 (1971), which had held that, in the case of commingled funds, the priority provisions of the Bankruptcy Act overrode the trust created by 26 U.S.C. 7501. See 401 U.S. at 517; see generally 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards). In 1978, cognizant of the practicalities of withholding tax collection, Congress concluded that "a serious problem exists where 'trust fund taxes' withheld from others are held to be property of the estate where the withheld amounts are commingled with other assets of the debtor" (*ibid.*; *id.* at 34,017 (1978) (statement of Sen. DeConcini)). Accordingly, it determined to relax the strict tracing rule derived from *Randall* (*ibid.*):

> The courts should permit the use of reasonable assumptions under which the Internal Revenue Service, and other tax authorities, can demonstrate that amounts of withheld taxes are still in the possession of the debtor at the commencement of the case. For example, where the debtor had commingled that amount of withheld taxes in his general checking account it might be reasonable to assume that any remaining amounts in that account on the commencement of the case are the withheld taxes.

Thus, even when trust fund taxes have not been paid over to the government, Congress contemplated that commingled funds could be identified as trust funds that can be obtained by the government because they should not be included in the property of the estate. It follows, *a fortiori*, that, where funds are actually paid to the IRS, prior to bankruptcy, to satisfy trust fund tax liabilities, payment from a special segregated tax account is not a prerequisite to preventing the bankruptcy estate from recovering those payments on the theory that the funds were not trust funds but rather were the property of the debtor. Thus, the court of appeals below correctly held that payments of outstanding trust fund tax liabilities

are not preferences that may be recovered by the bankruptcy trustee under Section 547.

2. We agree with petitioner that the decision below cannot be reconciled with *Drabkin* v. *District of Columbia*, *supra*. In that case, the trustee in bankruptcy sought to recover as a preference payments of withheld income taxes that had been made to the District of Columbia within the 90-day period prior to bankruptcy.[4] A divided court of appeals affirmed the district court's order holding the payment to be a voidable preference. The *Drabkin* majority dismissed as "inapposite" (824 F.2d at 1113) the explicit statement in the House Report that pre-petition trust fund payments are not avoidable, which was heavily relied upon by the court below (see Pet. App. A13-A14), stating that it was addressed to the "on account of an antecedent debt" requirement of Section 547 (b)(2) and referred only to withholding tax payments made before the tax is due (824 F.2d at 1113; *id.* at 1117 n.41). The court then concluded that the "mere fact of pre-petition payment" earmarked to satisfy a trust fund obligation is not sufficient to identify funds as being held in trust for the government and therefore to prevent the transfer from being avoided under Section 547. 824 F.2d at 1116-1117. See also *In re R & T Roofing Structures & Commercial Framing Inc.*, No. 87-2985 (9th Cir. Oct. 23, 1989) (relying on *Drabkin* in a case involving IRS seizure during 90-day period).

The decision below directly conflicts with *Drabkin*. The court below acknowledged that *Drabkin* had "squarely addressed" the question presented here (Pet. App. A12),

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[4] Thus, the trust relied upon by the D.C. government in *Drabkin* was not imposed by 26 U.S.C. 7501, but rather by D.C. Code Ann. § 47-1812.8(f)(1) (1980). The court of appeals in *Drabkin* ascribed no significance to this fact, noting that the federal statute "essentially mirrors" the D.C. statute. 824 F.2d at 1105; see also *id.* at 1117 n.1 (Ruth Ginsburg, J., dissenting). The D.C. Circuit discussed in detail the legislative history that focused on Section 7501, and its opinion leaves no doubt that it would have reached the same result had the case involved the United States as tax collector, rather than the District of Columbia.

but found "the *Drabkin* dissent convincing" (*id.* at A13) and reached the opposite result. The court below discussed the reasoning of the *Drabkin* majority in great detail, and rejected it. The court specifically noted its disagreement with the *Drabkin* majority's dismissal of the House Report (see *id.* at A15 n.11), with its failure to recognize the relevant legislative history's specific focus on withholding taxes, as opposed to other tax liabilities (see *id.* at A18), and with its failure to "distinguish between pre-petition payment of withheld taxes and a post-petition action by the IRS to recover withheld taxes in the possession of the estate" (*ibid.*). In short, the court below agreed that the *Drabkin* majority's legal analysis was fully applicable to the facts here, it considered that analysis in great detail, and it concluded that the *Drabkin* majority had erred.

There is thus no doubt that a bankruptcy trustee's efforts to recover pre-petition payments of trust fund tax liabilities under Section 547 will yield different results on the same facts in the Third Circuit and the D.C. Circuit. Because of the administrative importance of this issue, resolution of this conflict in the circuits is warranted. Many thousands of business bankruptcies are filed each year, and bankrupt businesses typically have outstanding trust fund tax liabilities. Undoubtedly, a large number of these cases will involve payments of trust fund taxes within the 90 days prior to filing for bankruptcy, which would present the opportunity for an action by the trustee raising the question presented here. Indeed, there has already been considerable litigation in the bankruptcy courts on this issue (see Pet. App. A12), and the volume of that litigation may well increase in light of the recently emerged conflict. Depending upon the size of the business, these cases may involve considerable sums of money; in this case alone, the debtor made a total of more than $1.6 million in trust fund tax payments within the 90-day period (although some of those payments came from a segregated account). Because of the importance of resolving this conflict in the circuits, we do not oppose the granting of certiorari.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

SHIRLEY D. PETERSON
Assistant Attorney General

GARY D. GRAY
JANET KAY JONES
Attorneys

NOVEMBER 1989

☆ U. S. GOVERNMENT PRINTING OFFICE: 1989 262203 623

No. 89-393

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

HARRY P. BEGIER, JR., TRUSTEE,
Petitioner

— v. —

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE
Respondent.

On Writ of Certiorari to the
United States Court of Appeals
for the Third Circuit

JOINT APPENDIX

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**Counsel of Record*

Petition for Writ of Certiorari Filed September 11, 1989
Certiorari Granted January 8, 1990

PACKARD PRESS / LEGAL DIVISION, 1617 JFK BOULEVARD, PHILA., PA 19103 (215) 563-9000

JOINT APPENDIX
TABLE OF CONTENTS

APPENDIX A

Plaintiffs	*Defendants*
HARRY P. BEGIER JR. TRUSTEE FOR AMERICAN INTERNATIONAL AIRWAYS INC.	UNITED STATES OF AMERICAN, INTERNAL REVENUE SERVICE

Attorneys

PAUL WINTERHALTER 1900 Spruce St. Philadelphia, PA 19103	STUART J GLICK Trial Attorney, Tax Division U.S. Department of Justice P.O. Box 227 Ben Franklin Station Washington, DC 20044

Date	*NR.*	*Proceedings*
Sept 18	1	COMPLAINT filed.
Sept 22 1987	2	SUMMONS and NOTICE OF TRIAL issued.
Feb 11	3	MOTION for Judgment on the Pleadings or in the Alternative, Summary Judgment filed 2/11/87 by Stuart Glick, Esq. jmr
Feb 11	4	Certification of Service of Motion for Judgment filed 2/11/87 by Stuart Glick, Esq. jmr
Feb 13	(3)	ORDER entered 2/11/87 requiring answer to Motion for Summary Judgment within 15 days of service.
	(3)	NOTICE OF HEARING re: Motion for Summary Judgment on 3/11/87. (1 notice)
Mar 4	5	RESPONSE OF THE UNITED STATES to the Plaintiff's Request for Production of Documents filed 3/4/87 by Edward Snyder, Esq. jmr
May 7		Hearing re: Complaint continued to 8/6/87. jmr

Date	*NR.*	*Proceedings*
May 19	6	PRE-TRIAL ORDER entered that having been reported that defendant agreed to withdraw its motion for judgment; it is ordered that hearing on the merits shall be continued until 8/6/87 at 10:00 a.m.; that all discovery be completed on or before 6/20/87. If any party contends that the other has failed to make discovery, the party seeking discovery shall file an appropriate motion to compel discovery on or before 6/26/87. If any motion to compel is filed, a hearing shall be held on 7/9/87. By 7/31/87 all parties are directed to file a list of all witnesses, copies of exhibits and a written stipulation of all undisputed facts. NO FURTHER CONTINUANCES OF THIS MATTER WILL BE FAVORED. pg. (2 notices)
May 22	(3)	MOTION to Withdraw Motion for Judgment on the Pleading and Certification of Service filed 5/21/87 by Stuart J. Glick, Esq.
May 22	(3)	ORDER entered 5/22/87 that the Motion is deemed withdrawn without prejudice. (2 notices).
Aug 7	7	STIPULATION of Facts filed 8/7/87 by Paul Winterhalter, Esq and Stuart Glick, Esq. jmr
Aug 25	8	MOTION for Summary Judgment, Memorandum in Support of Motion and Certification of Service filed 8/21/87 by Stuart Glick, Esq. jmr
	9	PRETRIAL STATEMENT, Exhibits and Certification of Service filed 8/21/87 by Stuart Glick, Esq. jmr
	10	Trustee's MEMORANDUM OF LAW and Certification of Service filed 8/21/87 by Paul Winterhalter, Esq.

Date Filed	*Date of Entry*	*Doc. Num.*	*Record*
1987			
	Sept 1	11	ORDER entered 9/1/87 that: 1) Parties shall prepare a supplemental Stipulation of Facts by 9/11/87, 2) Parties shall file Briefs in support of their positions, Plaintiff By 10/9/87, Defendant by 10/19/87, Plaintiff's Reply Brief by 10/23/87 and Defendant's Reply Brief by 10/28/87. (2 notices).
	Sept 1	12	MOTION to Amend Answer filed 9/1/87 by Stuart Glick, Esq.
	Oct 15	13	Declaration of Diane Wiktorski, Technician for the IRS filed.
	Oct 15	14	MOTION to Clarify or Grant Relief from Stipulation of Facts filed by Stuart Glick, Esq.
	Oct 16	(12)	ORDER entered 10/16/87 requiring Answer within 15 days of service.
		(12)	NOTICE OF HEARING re: Motion on 11/18/87. (1 notice). jmr
		(14)	ORDER entered requiring answer within 15 days of service.
		(14)	NOTICE OF HEARING re: Motion on 11/18/87. (1 notice).
	Oct 20		Hearing re; Motion for Relief held.
Oct 19	Oct 21	15	Trustee's RESPONSE to Defendant's Motion to Alter Admissions and Certification of Service filed by Paul Winterhalter, Esq.

Date Filed	*Date of Entry*	*Doc. Num.*	*Record*
		16	ORDER entered 10/21/87 that the Motion to Clarify or Grant Relief is Granted in part and Defendant shall pay the sum of $375. as reasonable counsel fees to the Trustee as a condition for the allowance of this Motion. (2 notices). jmr
		17	SECOND PRE-TRIAL ORDER entered that: 1) The matter is scheduled for 11/17/87, 2) The parties shall file by 11/10/87, a list of all witnesses, copies of all exhibits AND a supplemental written stipulation of all undisputed facts, 3) Parties shall file any Supplementary Memorandum of Law by 11/10/87 and NO FURTHER CONTINUANCES shall be allowed (2 notices). jmr
Nov 5	Nov 6	18	MOTION to Alter or Amend Order and MEMORANDUM OF LAW in Support of Motion to Alter or Amend Order and Certification of Service filed by Stuart Glick, Esq.
		(18)	NOTICE OF HEARING re: Motion on 12/2/87.
		(18)	ORDER entered requiring answer within 15 days of service. (1 notice). jmr
Nov 10	Nov 12	19	TRIAL BRIEF of USA and Certification of Service filed by Stuart Glick, Esq.

Date Filed	*Date of Entry*	*Doc. Num.*	*Record*
		20	REVISED PRETRIAL STATEMENT, Exhibits and Certification of Service filed by Stuart Glick, Esq.
Nov 12	Nov 12	21	TRUSTEE'S PRETRIAL STATEMENT filed by Paul Winterhalter, Esq.
		22	ERRATUM SHEET filed by Stuart Glick, Counsel to USA. jmr
	Nov 17		Hearing re; Complaint – Held under Advisement. jmr
Nov 17	Nov 18	23	Plaintiff's RESPONSE to Defendant's MOTION to ALTER or AMEND Order and Certification of Service filed by Paul Winterhalter, Esq. jmr
Nov 18	Nov 19	24	ORDER entered that: 1) Transcript of the hearing of 11/17/87 shall be ordered by Plaintiff, 2) Parties shall file Briefs – Plaintiff within 20 days of report, Defendant within 20 days of receipt of Plaintiff's Brief. (2 notices). jmr
	Dec 2		
Dec 2	Dec 3	25	Hearing re; Motion of USA to alter and amend Order held – ORDER entered that the Defendant's Request to Alter is DENIED.
Dec 17	Dec 18	26	Trustee's MOTION to Open the Record filed by Paul Winterhalter, Esq.
		26	NOTICE OF HEARING to Consider Motion on 1/27/88

Date Filed	*Date of Entry*	*Doc. Num.*	*Record*
		26	ORDER entered requiring answer within 15 days of service. (1 notice)
1988			
Dec 30	Jan 5	27	TRANSCRIPT OF HEARING held 11/17/87 filed.
Jan 12	Jan 13	28	Certification of Service of Motion to Open Record filed by Paul Winterhalter, Esq. jmr
Jan 11	Jan 19	29	OPPOSITION of the United States to Trustee's Motion to Open the Record, Exhibits and Certification of Service filed by Stuart Glick, Esq. jmr
	Jan 19	30	TRANSCRIPT of Hearing held 11/17/87 filed.
	Jan 27		Hearing re: Motion to Open Record – Settled – Stipulation to be filed. jmr
Feb 2	Feb 3	31	STIPULATION Filed by Paul Winterhalter, Esq. and Stuart Glick, Esq. admitting evidence without objection and Certification of Service. jmr
		32	Trustee's SUPPLEMENTAL MEMORANDUM OF LAW Exhibits and Certification of Service filed by Paul Winterhalter, Esq.
Feb 22	Feb 24	33	SUPPLEMENTAL MEMORANDUM OF LAW and Certification of Service filed by Stuart Glick, Esq.

Date Filed	*Date of Entry*	*Doc. Num.*	*Record*
Mar 9	Mar 10	34	OPINION AND ORDER entered that judgment is entered in favor of Trustee and Plaintiff and against United States of America, IRS in the amount of $700,410.33.pg
Mar 15	Mar 17	35	MOTION for Extension of Time to File Appeal from the Order of 3/9/88 filed by Stuart Glick, Esq.
Mar 18	Mar 21	36	ORDER entered approving extension of time to File Appeal to 4/8/88. (2 notices)
Mar 21	Mar 22	37	NOTICE OF APPEAL re: Order of 3/9/88 filed by Edward Snyder, Esq. jmr
	Mar 23	38	WITHDRAWAL of Notice of Appeal filed by Stuart Glick, Esq.
Apr 7	Apr 11	39	NOTICE OF APPEAL from the Order of 3/9/88 filed by Stuart Glick, Esq. jmr
Apr 22	Apr 25	40	United States' Designation of Record and Issues on Appeal filed by Stuart Glick, Esq.
		41	Certification of Service of Record and Issue filed by Stuart Glick, Esq.
	Apr 25	42	UNITED STATES' AMENDED DESIGNATION OF RECORD AND ISSUES ON APPEAL AND Certification of Service filed by Stuart Glick, Esq. jmr
	May 2		Appeal Sent to District Court.

Date Filed	*Date of Entry*	*Doc. Num.*	*Record*
	May 2	43	Appellee's Designation of Additional Items to be Included in the Record on Appeal and Certification of Service filed by Paul Winterhalter, Esq.
Sept 16	Sept 19	44	Copy of ORDER ENTERED 8/15/88 from US District CA #88-3529, that the Order entered 9/9/88 from BKY Court is Affirmed and the Orders entered 10/21/87 & 11/3/87 from BKY Court are Reversed & Vacated, by the Hon. Donald W. Vanartsdalen.
Sept 16	Sept 19	45	Appeal Returned from US District Court
Oct 17	Oct 17	46	Memorandum from US District Court requesting the return of the record on appeal CA #88-3529
	Oct 17		Appeal & Supplement to appeal returned to US District Court, CA 88-3529
Oct 18	Oct 19	47	Acknowledgement from US District Court of appeal, CA 88-3529
1989			
Jun 5		48	Case closing report prepared. ek

Plaintiffs	*Defendants*
BEGIER, HARRY P., Trustee	UNITED STATES OF AMERICAN, INTERNAL REVENUE SERVICE

Attorneys

Harry P. Beiger, Jr., Esq.
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Philadelphia, PA 19103

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1900 Spruce St.
Philadelphia, PA 19103

Stuart J. Glick, Esq.
Trial Attorney, Tax Division
U.S. Department of Justice
P.O. Box 227
Ben Franklin Station
Washington, DC 20044

Date	*NR.*	*Proceedings*
1988		
Apr 1	29	Certificate of Appeal from Order of Bankruptcy Judge entered on 3/9/88, filed.
Apr 2	29	Briefing Schedule, filed.
May 3	10	Certificate of Appeal, Supplemental Index from Order of Bankruptcy Judge entered on 3/9/88, filed.
May 4	16	Govt's brief for the Appellant, filed.
Jun 5	6	Brief of Appellee, filed.
Jul 5	5	GOVT. MOTION FOR A CONTINUANCE, & CERT. OF SERVICE, FILED.
Jul 6	8	ORDER THAT THE HEARING SCHEDULED FOR 7/25/88 AT 9AM IS CONTINUED TO 8/15/88 AT 9:30 A.M., FILED. 7/8/88 entered & copies mailed
Aug 7	15	Hearing re: sur appeal from the order of the bankruptcy judge on 3/9/88, Bench Opinion the decision of the bankruptcy judge in favor of the trustee is affirmed on the issue of avoidance. The decision of the bankruptcy judgment on the issue of attorney's fees is reversed, filed.

Date	NR.	Proceedings
Aug 8	15	ORDER THAT THE DECISION AND ORDER OF U.S. BANKRUPTCY JUDGE DAVID A. SCHOLL ENTERED 3/9/88 IN ADVERSARY PROCEEDING 86-1076 IS AFFIRMED AND THAT THE ORDER OF THE BANKRUPTCY JUDGE ENTERED 10/21/87 IN SAID ADVERSARY PROCEEDING AWARDING COUNSEL $375 IN COUNSEL FEES TO THE TRUSTEE IN BANKRUPTCY AND THE ORDER OF NOVEMBER 3, 1987, DENYING THE GOVERNMENT'S MOTION FOR RECONSIDERATION OF THE AWARD OF COUNSEL FEES, ARE REVERSED AND SAID ORDERS ARE VACATED, FILED. 8/16/88 entered & copies mailed
Sep –	16	Original record (#1 & 3) returned to Bky. Ct.
Sep X	20	Receipt re: original file, filed.
Oct 10	3	Transcript of Hearing of 8/15/88, filed.
Oct 11	13	Govt's Notice of Appeal, filed. (USCA 88-1788) 10/17/88 copies to: H.P. Begier, Jr.; Esq.; P.J. Winterhaiter, Esq., Clerk, USCA, VanArtsdalen, J,
Oct 12	13	Copy of Clerk's Notice to Clerk, USCA, filed.
Oct –	17	Original record (Papers 1 & 3) returned from Bky. Court.
Oct 13	26	Copy of Transcript Order, filed.

Date	NR.	Proceedings
Oct – 1990	27	RECORD COMPLETE FOR PURPOSES OF APPEAL-TRANSCRIPT ALREADY ON FILE.
Jan 4	10	Copy of Order Supreme Court of the United States that the petition for a writ of certiorari to the U.S. Court of Appeals for the Third Circuit is granted and the parties are to adhere to the following briefing schedule etc., filed.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT
Docket No. 88-1788

BEGIER, HARRY P., JR., *Trustee*	:	APPELLANT/PETITIONER:
	:	Gary D. Gray, Esq.
	:	11/30/88
vs.	:	Gary R. Allen, Esq.
	:	10/31/88
UNITED STATES OF AMERICA INTERNAL REVENUE SERVICE, *Appellant*	:	Wynette J. Hewett, Esq.
	:	12/5/88
	:	Chief, Appellate Section
	:	U.S. Department of Justice
	:	Tax Division
	:	P.O. Box 502
	:	Washington, D.C. 20044
	:	202-633-3361/FTS-633-3361
	:	
	:	APPELLEE/RESPONDENT:
	:	Paul J. Winterhalter, Esq.
	:	10/27/88
	:	Ciardi, Fishbone & DiDonato
	:	1900 Spruce Street
	:	Phila., PA 19103
	:	215-546-4370
	:	[Appellee,
	:	Harry P. Begier, Jr.,
	:	Trustee]

Date 1989	FILINGS – PROCEEDINGS
Jan. 31	At oral argmt. cnsl directed to submit memos re: separate accounts. Appellant to file within 7 days; appellee may respond seven days after. (ab)
Feb. 9	Mot. of aplt. for X of time to file gov't. response to aplee's supp. B from 2-14-89 to 2-21-89, filed. (gt)
Feb. 13	Order (Hutchinson, Scirica & Nygaard, C.J.) granting above motion, filed. (dr)
Jul 13	Oder Amending Opn. (Hutchinson, Scirica & Nygaard) fld. (bj)
Aug 3	Motion of Appellee For Stay of Mandate, w/serv. fld. (bj)
Aug 4	Order (Scirica, CJ) granting above Motion to & incl 9-3-89, fld. (bj)
Aug 31	Motion by Aplee for further Stay of Mandate, of additional 15 days to and including Sept. 18, 1989, w/serv. fld. (bj)
Sept. 5	Order (Scirica, C.J.) Further staying the issuance of the mandate to and incl. Sept. 18, 1989, filed. (ch)

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN RE:	:	CHAPTER 11
AMERICAN INTERNATIONAL	:	
AIRWAYS, INC.	:	BKY. NO. 84-02379K
Debtor	:	
HARRY P. BEGIER, JR., Trustee	:	ADV. NO. 86-1076
Plaintiff	:	
vs.	:	
UNITED STATES OF AMERICA	:	
INTERNAL REVENUE SERVICE	:	
Defendant	:	

COMPLAINT

The Complaint of Harry P. Begier Jr., Esquire, Trustee, by his attorneys, Ciardi, Fishbone & DiDonato, respectfully represents:

1. This adversary proceeding is brought pursuant to Bankruptcy Rule 7001 and Section 547(b) of Title 11, United States Code.

2. On July 19, 1984, American International Airways, Inc. ("Debtor") filed a Petition under Chapter 11 of Title 11 of the United States Code. Debtor's principal place of business at all times pertinent hereto was 2655 Philmont Avenue, Huntingdon Valley, Pennsylvania 19006.

3. Plaintiff, Harry P. Begier, Jr., ("Plaintiff") is the duly appointed, qualified and acting Trustee in the above-captioned bankruptcy matter.

4. Defendant is the United States of America, Internal Revenue Service, (hereinafter "Defendant").

5. This Court has jurisdiction over this adversary proceeding based upon 28 U.S.C. Section 1334(b), in that it arises under Title 11 of United States Code. This is a "core proceeding" under 28 U.S.C. Section 157(b)(2)(F). Venue is proper in this Court.

COUNT I

6. Paragraphs 1 through 5 are incorporated herein as if fully set forth.

7. On or about May 1, 1984, which date is on or within the period 90 days preceding the filing of the Bankruptcy Petition as described in paragraph 2 hereof, the Debtor paid $734,797.71 by check number OV5379 to the Defendant on account of an antecedent debt.

8. Said transfer was made while the Debtor was insolvent.

9. Said transfer will enable Defendant to recover more than it would receive as a creditor if (a) the bankruptcy case were a case under Chapter 7 of Title 11, United States Code; (b) the transfer had not been made; and (c) Defendant received payment of such debt to the extent provided by the Bankruptcy Code.

WHEREFORE, Plaintiff prays that the transfer by the Debtor to Defendant be avoided, that Plaintiff have a judgment against Defendant for $734,797.71, plus Plaintiff's costs, interest from the date of the transfer, and that he have such other and further relief as your Honorable Court finds just and proper.

COUNT II

10. Paragraphs 1 through 5 are incorporated by reference herein as if fully set forth.

11. On or about June 27, 1984, which date is on or within ninety (90) days preceding the filing of the Bankruptcy Petition as described in paragraph 2 hereof, the Debtor paid $200,000.00 by check number OV6112 to the Defendant on account of an antecedent debt.

12. Said transfer was made while the Debtor was insolvent.

13. Said transfer will enable defendant to recover more than it would receive as a creditor if (a) the bankruptcy case were a case under Chapter 7 of Title 11, United States Code; (b) the transfer had not been made; and (c) Defendant received payment of such debt to the extent provided by the Bankruptcy Code.

WHEREFORE, Plaintiff prays that the transfer by the Debtor to Defendant be avoided, that Plaintiff have a judgment against defendant for $200,000.00, plus Plaintiff's costs, interest from the date of the transfer, and that he have such other and further relief as your Honorable Court finds just and proper.

COUNT III

14. Paragraphs 1 through 5 are incorporated by reference herein as if fully set forth.

15. On or about July 6, 1984, which date is on or within ninety (90) days preceding the filing of the Bankruptcy Petition as described in paragraph 2 hereof, the Debtor paid $11,636.35 by check number OV6164 to the Defendant on account of an antecedent debt.

16. Said transfer was made while the Debtor was insolvent.

17. Said transfer will enable Defendant to recover more than it would receive as a creditor if (a) the bankruptcy case were a case under Chapter 7 of Title 11, United States Code; (b) the transfer had not been made; and (c) Defendant received payment of such debt to the extent provided by the Bankruptcy Code.

WHEREFORE, Plaintiff prays that the transfer by the Debtor to Defendant be avoided, that Plaintiff have a judgment against Defendant for $11,636.35, plus Plaintiff's costs, interest from the date of the transfer, and that he have such other and further relief as your Honorable Court finds just and proper.

Respectfully submitted,
CIARDI, FISHBONE &
DiDONATO

By:_____
Paul J. Winterhalter, Esquire
Marc N. Bell, Esquire
Attorneys for Trustee

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re	:	Chapter 11
AMERICAN INTERNATIONAL AIRWAYS, INC.	:	
Debtor	:	Bankruptcy
HARRY P. BEGIER, JR., TRUSTEE	:	No. 84-02379K
Plaintiff	:	
v.	:	
UNITED STATES OF AMERICA, INTERNAL REVENUE SERVICE	:	Adversary No. 86-1076K
Defendant	:	

ORDER

AND NOW, this 21st day of October, 1987, upon consideration of the United States' MOTION TO CLARIFY OR GRANT RELIEF FROM STIPULATION OF FACTS, it is hereby ORDERED as follows:

1. The Motion is GRANTED in part and paragraph seven of the Stipulation shall be amended by addition of the following language "beginning no later than April, 1984. This Stipulation shall not preclude the Plaintiff from establishing that the date was earlier than April, 1984."

2. In light of the Plaintiff's reasonable reliance on the Defendant's earlier Stipulation that the Debtor was a monthly filer at all times pertinent to the time-period in issue, i.e., since January, 1984, in the preparation of the Trustee's Memorandum of Law, the Defendant shall pay the sum of $375.00 as reasonable counsel fees to the Trustee as a condition for the allowance of this Motion.

DAVID A. SCHOLL
UNITED STATES
BANKRUPTCY JUDGE
3722 United States
Court House
Philadelphia, PA 19106-1763

Copies to:
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Suzanne J. Young, Esq.,
Law Clerk
Joseph Simmons, Deputy in
Charge of Bankruptcy
Operations
ENTERED OCT 21, 1987

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF PENNSYLVANIA

IN RE:	)	Bankruptcy Action 84-02379 86-1076 (11)
AMERICAN INTERNATIONAL AIRWAYS	)	Philadelphia, Pennsylvania November 17, 1987 A.M. Session

TRANSCRIPT OF HEARING
BEFORE THE HONORABLE DAVID A. SCHOLL
UNITED STATES BANKRUPTCY JUDGE

APPEARANCES:

For the Plaintiff: PAUL J. WINTERHALTER, ESQUIRE
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Proceedings recorded by Electronic Sound Recording, transcript produced by transcription service.

* * *

THE COURT: Let me just ask one question of Mr. Glick before we get rolling. Mr. Glick, are you really disputing the later – you don't even address it in your memo – the two

hundred thousand and the eleven thousand. It would seem to me those are preferential transfers, aren't they?

MR. GLICK: Your Honor, it is our position that the Trustee would have to prove that the property was, in fact, property of the estate. Payment of money held in trust for the United States is not property, so . . .

THE COURT: Well, we know that trust money isn't property of the estate. I already ruled that.

MR. GLICK: Well, we are saying that these monies consisted of trust funds as well. They were payments of trust fund taxes and it is our position, under the legislative history, that those payments are deemed to be trust funds and not part of the estate and the Trustee has the burden of showing that, in fact, these were not monies which were withheld from trust funds but which were . . .

THE COURT: Of course, you know, my ruling is that you have the burden of showing that – tracing the funds. If you can't do that, then I think you lose on that theory. I ruled it in the AIA – in this very case. Plus I reaffirmed that in another decision, the *Miller* case.

MR. GLICK: Yes, Your Honor.

THE COURT: Plus the DC Circuit, as Mr. Winterhalter points out, is the first circuit to go on record and agrees essentially with my position.

MR. GLICK: Yes, Your Honor. This is simply the position put forward by the Government.

THE COURT: All right. That – you know, that is not going to be too persuasive, but – so it seems to me that you lose on those two later – unless there is some other theory you have – on the two later transfers, but the big transfer is definitely some questions about the seven hundred whatever it is. Okay. Well, all right. Let's get the testimony.

MR. WINTERHALTER: Your honor, I believe the best starting point for this proceeding would be simply to bring to the Court's attention the stipulation which has been filed. Now . . .

THE COURT: As amended, right

MR. WINTERHALTER: That is correct, Your Honor.

* * *

Q. (by Mr. Winterhalter) Mr. Miller, showing you a document that has been marked as plaintiff's exhibit one, would you please examine that document?

A. I have.

Q. Have you examined it?

A. Yes.

Q. Can you identify this document, Mr. Miller?

A. Yes. This is check 5379 from the operating account of American International Airways, dated April 30th, 1984, payable to the Internal Revenue Service in the amount of $734,797.71.

Q. Briefly, Mr. Miller, what is the date of this check?

A. The date of the check is April 30th, 1984 and it cleared the Federal Reserve Bank on May 1st, 1984.

MR. WINTERHALTER: For the purposes of the record, Your Honor, this is the same payment that is referenced in the stipulation executed between the parties.

THE COURT: All right.

MR. WINTERHALTER: At this time, I would like to mark a document as plaintiff's exhibit two for purposes of the record. This is a copy of a treasurer's check.

Q. Mr. Miller, showing you a document that has been marked as plaintiff's exhibit two, will you please identify the document?

A. This is a photocopy of a treasurer's check from Industrial Valley Bank and Trust in the amount of $695,000 payable to the Internal Revenue Service on April 30th, 1984.

Q. What is the amount of this check, sir?

A. $695,000.

Q. Mr. Miller, briefly, in your head, can you calculate the total of payment number one — or plaintiff's exhibit number one and plaintiff's exhibit number two?

A. It is roughly one million, four hundred and thirty thousand dollars.

Q. Would it be correct to presume that the total payment is one million, four hundred and twenty-nine thousand, seven hundred ninety-seven dollars and seventy-one cents?

A. That, correct.

MR. WINTERHALTER: For the purposes of the record, Your Honor, that is, in fact, the exact amount that appears in the stipulation which the parties have filed.

THE COURT: All right. Well, I am sure we will be able to add those two together.

MR. WINTERHALTER: At this time, I would like to mark this original check plaintiff's exhibit three.

Q. Mr. Miller, showing you a check that has been marked as plaintiff's exhibit three, will you briefly examine that check.

A. I have examined it.

Q. Can you identify that check?

A. This is a check drawn on the American International Airways general operating account for $200,000 payable to the Internal Revenue Service. It is check number 6112, dated June 22, 1984 and it cleared the Federal Reserve Bank on June 26, 1984.

MR. WINTERHALTER: At this time, I would like to mark this exhibit as plaintiff's exhibit four for the purposes of identification.

Q. Mr. Miller, will you please examine this check.

A. I have examined it.

Q. Could you identify this check, sir?

A. This check is check number 6164, drawn on the operating account of American International Airways, made payable to Internal Revenue Service for the amount of $11,636.35. The check was drawn on June 24th, 1984 and cleared the bank on July 5th, 1984.

Q. Three out of the four of these checks came from the debtor's operating account; is that correct?

A. That's correct.

Q. Mr. Miller, at this time I would request — . . .

MR. WINTERHALTER: First I would request that this document, which has been previously marked as plaintiff's exhibit five, be so marked, for the purposes of this proceeding, as plaintiff's exhibit five.

Q. Mr. Miller, showing you a document that has been marked as plaintiff's exhibit five, will you please examine this document?

A. I have examined it.

Q. Mr. Miller, can you identify this document?

A. Yes, I can.

Q. Will you identify this document?

A. Yes, I will. This is a notice to American International Airways. It is a monthly filer. And, the notice was sent to AIA in February – it looks like 22nd, 1984.

* * *

Q. Mr. Miller, showing you a document that has been marked as P-13, can you possibly identify this document?

A. This is a photocopy of Section 31.6011, Subparagraph A-5, which is the requirements of the monthly returns.

THE COURT: Well, it is part of that section. It is only Subsection A.

MR. WINTERHALTER: That's correct. It is only Subsection A of that . . .

THE COURT: I guess it is still – it is in CFR, too, I presume.

MR. WINTERHALTER: Yes, it is 26 . . .

A. Yes, 26 CFR, Chapter One. The April 1st, '87 addition.

THE COURT: Okay. All right.

MR. WINTERHALTER: That's correct.

Q. Now, Mr. Miller, previously – just previously you testified as to the change of the – as to the change of the filing requirements upon receipt of the February 22nd notice in your brief colloquy with the Judge. I would like to direct your attention to the second column of that copy page, approximately halfway down, which is in the full body of the regulation . . .

MR. GLICK: Your Honor, the Government is going to have to object. He is not testifying as to fact now, he is just testifying as to law.

THE COURT: Yeah, where are you headed here? I mean, I can read it too.

MR. WINTERHALTER: Well, Your Honor, I was attempting to bring out exactly what the regulation requires.

THE COURT: All right. It sounds to me as if that is legal argument, really. All right. Sustained.

MR. WINTERHALTER: That's fine, Your Honor. I'll proceed with another course then. I ask you to set that aside.

Q. We have just recently marked P-6 then, can you identify this document?

A. This is a form 941 for January 1984, which is the Employer's Monthly Federal Tax Return for American International Airways, Inc. It was filed on March 15th, 1984.

Q. Mr. Miller, can you determine from this document what is – is this a document that is filed in the debtor's normal course of business?

A. When you are saying normal course of business, I would say no, because a normal course of business would be a quarterly filer and, you know, this is a document that had to be filed with regard to the February 1984 letter.

Q. Mr. Miller, from that document, can you determine how much tax was due for that particular period? What was the aggregate liability for that period?

A. AIA's liability to the Internal Revenue Service in January 1984 was $242,016.06 according to this tax return.

Q. Mr. Miller, is this document signed?

A. Yes, it is. It is signed by Bruce Edmundson, who is the President of AIA.

Q. And, is there a date opposite that signature?

A. March 15th, 1984. And, there is also a date, March 15th, 1984, as received by the Internal Revenue Service of Jenkintown, Pen – in the Jenkintown, Pennsylvania office.

MR. GLICK: Your Honor, the Government is going to have to object. This witness is testifying with respect to this document. He has laid no foundation that he knows that this document is, in fact, what it purports to be. It seems that you would have to have someone competent who can, in fact, know that it was the tax returns for January 1984 which was filed by American International Airways. Anybody can read what is on the face of the document, but to know that this was, in fact, a true document, I don't believe this witness is qualified to testify.

THE COURT: Well, where did he see this? Where did you see it, Mr. Miller? Did you see it — how did you first . . .

A. I mean, I saw it in Mr. Winterhalter's office when we were preparing for the case.

MR. WINTERHALTER: Your Honor, if I may, this is also Government document number 12.

THE COURT: Oh, are you offering this too?

MR. GLICK: We will offer it to our witness, and we believe our witness to be the one who is qualified to testify with respect to it.

THE COURT: All right.

MR. GLICK: The question is whether or not this witness is, in fact, competent to testify with respect to this. He can state what it appears to be, but as a fact of what it is, it is the same testimony as if anyone . . .

THE COURT: All right. Well, okay. Maybe that's a fine line. All right. It seems to me that there is no dispute that it is genuine but all right.

MR. WINTERHALTER: I would believe that too. And, it really goes to the weight of the evidence, Your Honor, it doesn't go to . . .

THE COURT: It is not clear to me that you have established that this is something Mr. Miller found in the business records. He says he found it in your office.

MR. WINTERHALTER: That is correct, Your Honor.

THE COURT: But if you want to ask him — if there is something on here in particular you want to point him to, I'd certainly allow you to do that.

MR. WINTERHALTER: Your Honor, just for the record, I would like to review that the parties have stipulated, in fact, to when the payments were made and how those payments were applied.

THE COURT: All right. Well, if you did, then that is in the record anyway.

MR. WINTERHALTER: That's correct.

THE COURT: You don't have to put things in the record that are already in.

MR. WINTERHALTER: At this time, Your Honor, I would like plaintiff's exhibit seven to be marked.

THE COURT: In phrasing your questions, you'll phrase them consistent with what Mr. Glick had suggested. All right. Go ahead.

(Pause).

Q. Mr. Miller, showing you a document that has been marked as plaintiff's exhibit seven, can you identify this document?

A. Yes, 941M, Employer Monthly Federal Tax Return for February 1984 for American International Airways, Inc.

Q. Mr. Miller, with your accounting experience, can you determine from the face of this document what is the purported aggregate tax liability for this period?

A. The liability for February 1984 would be $212,962.21.

MR. WINTERHALTER: For purposes of the record, Your Honor, this document is also Government exhibit number 11.

THE COURT: All right.

A. Could I just correct that. It is $902.21, $212,902.21.

MR. WINTERHALTER: Thank you.

Q. Mr. Miller, I want to refer you back now to plaintiff's exhibit five. Plaintiff's exhibit five is the February 22nd notice. You previously testified that the notice required monthly filing.

A. Yes.

Q. Based on plaintiff's exhibit six and plaintiff's exhibit seven, does it appear that these documents were filed in response to that notice?

MR. GLICK: Objection. It is just conjecture.

THE COURT: I think it would be, wouldn't it, Mr. Winterhalter? I'd sustain it.

MR. WINTERHALTER: All right, Your Honor.

Q. Based on — you've testified as to plaintiff's exhibit five. You've also testified that these two returns appear to have been filed and these were — these reflect the tax liability purportedly of the debtor corporation for January and February. Just one final question on plaintiff's exhibit seven. When does it appear that plaintiff's exhibit seven, which is the February 1984 return, was filed?

A. March 15, 1984.

THE COURT: That's because of the received stamp on that?

A. Well, it is signed down here. That is when you are supposed to sign it, the date you send it, and it says received, Internal Revenue Service, Jenkintown, Pennsylvania, March 15th, 1984.

THE COURT: How would they get it the same day it is signed? Do you have any . . .

A. It probably was hand-delivered. When you file these returns in accordance with this letter, it has to be sent to the district director, just not sent to the Internal Revenue Service, Philadelphia, Pennsylvania 19255. It's got to be sent to the identified person in the letter.

MR. WINTERHALTER: At this time, Mr. Miller, I would request that this document be marked as plaintiff's exhibit eight.

Q. Showing you a document that has been marked as plaintiff's exhibit eight, would you please examine that document.

A. I've examined it.

Q. Can you identify that document?

A. Well, this is a form 941, which was made to be a 941M and is filed as a monthly — Employer's Monthly Federal Tax Return for American International Airways for the month of March 1984. It was filed on April 14th, 1984 and signed by a Mr. Bruce Edmundson.

MR. GLICK: Objection, Your Honor. It appears to be signed by Mr. Bruce Edmundson. The Government would object whether or not the plaintiff has knowledge, just for the record.

THE COURT: All right. Is that what it appears to be?

A. That looks like the same signature that he signs in the Board of Directors minutes and other areas where he has been an authorized signer. I have seen his signature hundreds of times.

THE COURT: All right. But you are just testifying to what it appears to you looking at it?

A. Yes.

THE COURT: All right.

MR. GLICK: Your Honor, for the record, the Government would state that plaintiff's exhibit six . . ..

THE COURT: Eight this is.

MR. GLICK: Well, six through 12 are what they purport to be, if that would clear things up.

THE COURT: Oh, all right. Okay. Thank you. Okay. Go ahead, Mr. Winterhalter.

Q. Mr. Miller, a quarterly filer for 941 taxes, when — his taxes are due when?

A. Well, tax liability arises the date that the payroll tax is purportedly withheld from the payroll, so I am kind of, you know, if you are saying, when is the taxes due, we, you are required to make a deposit based on the amount of taxes withheld within a specific period of time or when the liability arises. The liability to the Internal Revenue Service would arise at the time the payroll taxes are purported withheld from your paychecks.

Q. Mr. Miller, are you familiar with the requirements that taxes be withheld? Are you familiar with those requirements?

A. Yes, I am.

Q. And, based on your familiarity, what is your understanding?

A. Okay. When you with — if you have a payroll, and this is with regard to payroll taxes, if you have a payroll and let's say it is on November 17th, and that payroll exceeds where there is going to be more — in excessive of $3,000 in payroll taxes withheld, you are required within three days of November 17th to make a deposit in an approved federal list — you know, federal reserve institution, most likely a commercial bank, of the monies that were withheld purportedly as of November 17th. So, specifically, let's say you had $5,000 in payroll taxes withheld or should have been withheld on November 17th, that deposit had to be made at, let's say, First Pennsylvania Bank by November 20th with, you know, a federal deposit coupon advice or something like that. And, that's when the payment of those taxes should have been on deposit at the federal, you know, federal approved institution.

Q. Mr. Miller, when does the liability arise?

A. When the tax is withheld from the paychecks.

Q. What happens if the employer doesn't pay the tax within that time frame?

MR. GLICK: Again, objection. He's – it is legal argument that he is raising. If he wants to state his opinion of what he believes it to be, that's one thing. But just to state what is the law, I believe that is a matter for the Court not the witness.

THE COURT: Well, to a certain degree, I think that is correct. I'll sustain that.

MR. WINTERHALTER: Thank you, Your Honor.

Q. Mr. Miller, is it your opinion that most taxpayers pay the employment taxes in this fashion?

A. Well, most tax – you have to comply to certain rules, so most taxpayers, you know, comply with the rules. If you are withholding . . .

MR. GLICK: Objection as irrelevant, Your Honor.

THE COURT: Yeah. Just what do they do, Mr. Miller?

A. Well, this $3,000 is a three-day banking rule which would be – that AIA would qualify under. But like certain companies woudn't qualify under the three-day banking rule because their payroll would be less and there is other rules to be followed.

THE COURT: Well, let's assume they are over $5,000 – $3,000.

A. So if it is over – if it is a three-day banking rule, yes, they would be required to make the payment of taxes withheld from the employees paychecks within three banking days of the payroll period. So that would mean – you know, most pay periods for a lot of companies end on a Friday, that deposit would have to be made by the following Wednesday because that is their banking day. Saturday and Sunday wouldn't be included in there.

MR. WINTERHALTER: I would request that this document be marked as P-9.

Q. Mr. Miller, showing you a document that has been marked as P-9, please examine this document.

A. I've examined it.

Q. Can you identify it?

A. This is the . . .

THE COURT: What does it appear to be?

A. This appears – this appears to be a form 941M, Employer's Monthly Federal Tax Return for May 1984, for American International Airways, which was filed on May 15th, 1984, received on May 15th, 1984 by the director of the Internal Revenue, Jenkintown, Pennsylvania. Excuse me, Your Honor. Could I just check – I've got some records in my brief case I would like to just check and I might be able to identify these records better if I can compare them.

THE COURT: All right. Sure.

MR. WINTERHALTER: Your Honor, I would request a five minute recess.

THE COURT: All right.

MR. MILLER: I don't need that long. I just need to pull out.'.

THE COURT: Well, we will take a minute until Mr. Miller checks his records..

(Pause).

THE COURT: All right. You can't really discuss that with Mr. Winterhalter.

MR. MILLER: No. See, Your Honor, what I wanted to. . .

MR. GLICK: Your Honor, there is no question pending.

THE COURT: Yeah. All right. Go ahead, Mr. Winterhalter.

Q. Mr. Miller, you presently before you have, I believe, plaintiff's exhibit nine, if I am not mistaken.

A. Yes.

Q. And, can you identify what it purportedly is – or purports to be? And, simply for the continuity of the record, does this document also contain the same signature that appears on the other documents?

A. Yes. I would also like to clarify something with regard to at least P-7, P-8 and P-9, with regard to the question if it is a company record.

MR. GLICK: Objection, Your Honor. There is no question . . .

THE COURT: Yeah, there's no questions. I will have to stop you there, Mr. Miller. All right, Mr. Winterhalter.

Q. Mr. Miller, is this a company record?

A. Yes, The reason I know that this one, P-9, is a company record, is because this one is stamped received and the return it was given – I had copies of all these returns. I had some that were from company records and some that were given to us by the Internal Revenue Service. The Internal Revenue Service records are exact reproductions of these documents, except that they have the word timely written on the top of the filed return. So this return, which would be hand-delivered, the company would take, you know, having its own copy stamped when it would hand-deliver the record. And, then when the Internal Revenue Service would keep its record, there were certain notes made on the return which do not appear on P-7 through P-9. And, those notes do appear on the Internal Revenue Service's return.

Q. Mr. Miller, P-9, I direct your attention to the notations made in response to inquiry number 13, or question number 13, I am not exactly sure how it should be properly phrased, but number 13 on the return itself. And, I am asking . . .

THE COURT: You mean line 13?

MR. WINTERHALTER: Yes.

Q. Number 13. I am asking you to explain this for me, please. On number 13, aside from that, there is three columns. Tax liability – and I am reading directly from the document – tax liability for period, date of deposit and amount desired. Now, what – can you explain these three columns for me on any – I am sure it appears on every return.

A. Okay. The first column is the tax liability for the period. If you have a payroll – and what this tax return has done . . .

THE COURT: Excuse me, where are you reading from right now?

A. Right here, Your Honor.

THE COURT: Oh, all right. I see it. Okay.

A. This tax liability for the period means you had a payroll that ended in this situation in period B, from the eighth of the month through the 15th day of the month. And, that the

amounts withheld in FICA taxes, F-I-C-A taxes, totalled $136,513.36. So your liability for that pay period to the Internal Revenue Service would be the $136,513.36. Because that amount is greater than $3,000, that should have been deposited within three banking days of the specific day that that deposit was made. I mean that, you know, liability was withheld and that deposit made, I'm sorry.

Q. Mr. Miller, does P-9 purport to show any monies deposited?

A. It has an aggregate deposit of $300,000 called the final deposit for the month. And, it has an overpayment of $48,624.48.

MR. WINTERHALTER: At this time I would like this document marked as plaintiff's exhibit ten. It is a two-page document.

Q. Showing you a document that has been marked as plaintiff's exhibit ten, will you please just briefly take a look at this.

A. I've read it.

Q. Mr. Miller, can you identify this document?

A. This is a letter to Milton Rosenthal of the Internal Revenue Service from Leonard Sarner, he was an attorney for AIA, referencing an agreement for the payment of 941 taxes.

MR. GLICK: Objection, Your Honor. We are not certain where the question is leading, but we would say that this document in and of itself would be hearsay. And, additionally, there has been no foundation that he has personal knowledge as to this document.

THE COURT: That's true. Sustained.

Q. Mr. Miller, what is – have you ever seen this letter before?

A. Yes, I have.

Q. Can you explain when, to the best of your recollection, you first saw this letter?

A. In your office in May of 1987.

Q. What was the purpose of your viewing that letter at that time?

A. It was evidence of an agreement for the payment of 941, which are the employees taxes and also the excise taxes which were due for this – in response to this February notice of what we received. As a matter of fact, the February notice is referenced in paragraph four of this letter, which is exhibit P-5, the February notice I am referring to.

MR. WINTERHALTER: For the purposes of the record, Your Honor, this would be Government exhibit number one.

THE COURT: Oh, I see. This is your exhibit too, Mr. Glick, this P-10?

MR. GLICK: It may be, Your Honor. We have it listed. We haven't made a determination as to whether or not we are going to be using it.

THE COURT: Well, all right. It would seem if you have it, it is probably legitimate then. All right. Go ahead.

MR. WINTERHALTER: At this time I would like to mark two documents at this time. Plaintiff's exhibit 11 and plaintiff's exhibit 12.

Q. Mr. Miller, showing you two documents that have been marked plaintiff's exhibit 11 and plaintiff's exhibit 12, I would like you to examine both of those documents.

A. I have.

Q. Directing your attention to plaintiff's exhibit 12 – excuse me, plaintiff's exhibit 11, will you please – can you identify this document?

A. Yes, I can.

Q. Will you identify this document for the Court?

A. Yes, I will. It is a photocopy of bank statements for American International Airways' special fund bank account that was opened in response to a notice received regarding Section 7512 of the Internal Revenue Code to establish a special bank account for the deposit of taxes. This changes the depository requirements of a taxpayer.

Q. Mr. Miller, in your practice, do you have occasion to view various bank statements of different clients?

A. Yes, As a matter of fact with regard to AIA I reviewed all the bank statements during this period and there is on P-12, a $695,000 internal charge on April 30th. And, that was the only

internal charge for $695,000 that I was able to ascertain. That would be the source of this treasurer's check from Industrial Valley Bank payable to the Internal Revenue Service.

Q. For the purposes of clarification of the record, will you please identify the account number for these – for the statement.

A. This is account number 0-802-304-2.

Q. Mr. Miller, I note, looking at the statement, the last statement date has 000000. Why would that be?

A. Okay. That is on P-11. That is because this account was not open until the deposit on March 22nd, 1984 for $108,765.31 was made. The last statement date means there was no preceding bank statement issued for that.

Q. So, therefore, this document indicates that this is a statement of the transactions in that account as of the statement date?

A. That's correct. There is an opening balance up there, zero, and an ending balance or closing balance, is what they call it, of $235,051.42.

Q. All right. And, that closing balance would also appear as the ending balance on P-12 – or excuse me, the opening balance on P-12?

A. That's correct.

Q. And, on P-12, which is – P-12 is the statement date for . . .

A. P-12 is the statement date for April 30th, 1984.

Q. On the same account?

A. Yes, it is.

Q. So this is just the following month's statement?

A. That's correct.

Q. And, out of this statement – well, based on the document before you, can you identify any charges out of this statement?

A. Yes. There is a $695,000 charge made on April 30th, 1984.

Q. Mr. Miller, the title of the account, can you briefly just explain what that language appears to be?

A. Okay. That is a specified language according to Section 7512 of the Internal Revenue Code. When a taxpayer for an — you know, is involved in an extraordinary situation for the failure to pay taxes, that the Internal Revenue Service may require it to file its taxes in accordance with Section 75 — file its deposits in accordance with 7512, whereupon a special Trustee bank account is created and the actual name of the account, as included on this Industrial Valley Bank statement, is the same as what is required under Section 7512.

Q. Mr. Miller, if the debtor was a monthly filer, . . .

A. Right.

Q. If he was a monthly filer, when would his return be due?

A. His return would be due the 15th of the following month. For example, if he was a Jan — monthly filer and he filed a January return it would be due on February 15th.

Q. And, that would be for 941 taxes?

A. Yes.

Q. Would the same be true for 720 taxes?

A. Yes.

* * *

THE COURT: Let me ask this. Did — what is the penalty? How do they measure it, do you know?

By Mr. Miller:

A. Well, Your Honor, that's why you have to fill out when the liability occurs because they compute it on a percentage from the day that you didn't make your deposit, based on when the liability to the Internal Revenue Service occurs.

THE COURT: I see. All right, Thank you.

By Mr. Glick:

Q. Sir, directing your attention to plaintiff's exhibit number eight, would the period which is down — looking under the column on the left-hand side under number two total, I'll — specifically lines T and U of that exhibit, . . .

A. T and U, okay.

Q. . . . would the figures to the right of T and U, summed together, would that be the amount of money which was — which should have been deposited after the payment for the week of 12 through 19?

A. Well, that's — no, not necessarily because in this situation line T could have been received on the 12th. If the payment — payroll was on the 12th and this should have been paid by the 15th. And, in U it was on the 16th and the payment would have been due by the 19th. So they would have been two different periods of times . . .

Q. So then there should have been — I'm sorry.

A. . . . where deposits had to be made. There should have been two separate deposits, one for $53,000 and one for $79,000.

* * *

MR GLICK: No further questions.

THE COURT: All right. You may step down. Thank you, Mr. Miller. Do you have any other witnesses, Mr. Winterhalter?

MR. WINTERHALTER: Your Honor, I do not have any other witnesses. However, I would like to move for the introduction of certain evidence.

THE COURT: All right.

MR. WINTERHALTER: If I may, I would like to introduce at this time — or move for the introduction of plaintiff's exhibit one, plaintiff's exhibit two, plaintiff's exhibit three, plaintiff's exhibit four, to which I do not believe you would have any objection.

MR. GLICK: No objection.

THE COURT: All right.

MR. WALTERHALTER: At the same time, Your Honor, I anticipate no objection on plaintiff's exhibit 11 and plaintiff's 12, bank statements.

MR. GLICK: No objection.

THE COURT: All right. Those would be admitted.

MR. WINTERHALTER: Your Honor, now I would like to address and move for the admission of plaintiff's exhibit six, seven, eight and nine, Your Honor.

MR. GLICK: I have no objection to those either, Your Honor.

THE COURT: All right. They will be admitted.

MR. WINTERHALTER: Now, Your Honor, I would like to move for the introduction of plaintiff's exhibit five.

MR. GLICK: The Government would object to that, Your Honor. I don't believe – according to Rule 602, the witness is only competent to testify with respect to documents of which he has personal knowledge. In this case, with respect to document P-5 and – that was the only one you just stated, P-5?

MR. WINTERHALTER: Yes.

MR. GLICK: With respect to P-5, he has stated he has no personal knowledge, he only looked at it in his attorney's office. So whether or not this is what it purports to be, I don't believe this witness is qualified to state.

THE COURT: Mr. Winterhalter?

MR. WINTERHALTER: Your Honor, I believe that this document is a document – is a business record of the debtor corporation. It appears self-evident that the document was addressed to Mr. Bruce Edmundson. Mr. Bruce Edmundson, without question, the witness has testified, was the chief executive officer and president of the debtor corporation during the time immediately preceding the bankruptcy filing. Certainly, Your Honor, the terms of the document speak for itself. It is a document which the Internal Revenue Service intends to introduce, intends to use in this proceeding, Your Honor. The document is frequently referenced throughout the entire statement of both the Internal Revenue Service's brief and of course from this brief, Your Honor. The filing requirements of the debtor corporation are referenced in this letter. For the testimony that is presented based on this document, I believe that there is proper foundation for the introduction of the copy of this letter, Your Honor. It is a business record of the debtor corporation and I believe it should be (indiscernible).

MR. GLICK: Your Honor, the position of the Government is whether or not the Government introduces it or whether or not it could put on a proper foundation is irrelevant to determine whether or not Mr. Miller is competent to testify with respect to this. And, Mr. Miller, is, in fact, competent to put this document into evidence through his testimony. That is the objection raised by the Government.

THE COURT: Well, I am going to allow it, because I think that to me we have the sufficient reliability established. And, I

think that is really the purpose of the business records rule. I believe that it can be admitted under that rule so I will admit it.

MR. WINTERHALTER: Thank you, Your Honor.

THE COURT: All right.

* * *

By Mr. Winterhalter:

Q. The letter that you – that was identified as plaintiff's exhibit five changed the filing requirements and this notice changed the deposit requirements?

By Mr. Zlatkin:

A. I would say – if I could state it in my own terms?

Q. Please do.

A. Okay. I would say that the letter gave official notice from the service to the taxpayer that they were no longer going to be a quarterly depositor. I would say that this form 2481 gave the specifics, in terms of instructions, to the taxpayer in this case as to how to accomplish filing, paying and depositing of taxes under this 7312 provision.

Q. How were they – what type of filer and depositor were they before this notice?

A. Not meaning to be funny, but they were poor filers and poor depositors. They didn't make deposits. That was the basis for submitting this recommendation and ultimately carrying it out.

Q. You were pursuing to protect the Internal Revenue Service's interest in collection of this account; is that correct?

A. That's correct.

Q. And, you served this in March of 1984; is that correct?

A. That's correct.

* * *

By Mr. Winterhalter:

Q. Okay. All right. I would like to direct your attention to Government exhibit number four. Just for the purposes of continuity, could you identify again this exhibit?

By Mr. Zlatkin:

A. Yes. This is a 720 monthly federal excise tax return with the annotation, timely, for American International Airways, Inc., for the month of February 1984.

Q. The annotation, timely.

A. Yes.

Q. When was this return filed?

A. Judging by the date stamped, if I could read it correctly, it looks like it was March 15th, 19— well, I can't read the rest of the year.

Q. The document was timely filed on March 15th? That is what it says, doesn't it?

A. That's what that says, yes.

Q. Now, we — on your direct examination you were referencing the requirements for depositing taxes and when penalties can be imposed for depositing taxes. I want to direct your attention to that line of questioning that Mr. Glick attempted to bring — or to enlighten this Court. Now, you're very familiar with the Internal Revenue Code; isn't that correct?

A. I am conversing with it. (sic: conversant)

Q. Yes, sir. A normal taxpayer is required to make tax deposits; isn't that correct?

A. That's correct.

Q. If he meets the requirements of so many dollars for so many periods, et cetera?

A. That's correct.

Q. And, to your knowledge, the debtor corporation, American International Airways, was required to make tax deposits; is that correct?

A. At which point — at what point?

Q. In — for the purposes of keeping the record clear — in the fourth quarter of 1983

A. That's correct.

Q. And, they were required to make them in January of 1984?

A. That's correct.

Q. But they didn't make them?

A. That's correct.

Q. All right. Now, to the penalties. You stated, and correct me if I am wrong, because I am not exactly certain that I followed it clearly, that if a party does not dep — any party, any

employer, does not timely deposit the tax obligation, they are — you tell me, please, are they or are they not assessed a penalty?

A. Yes, they are assessed a penalty.

Q. When are they assessed that penalty?

A. Only after the return is filed, at the due date of the return and an assessment is made for . . .

Q. What if — oh, please, don't . . .

A. I was just going to say an assessment is made for tax.

Q. What if a return is never filed?

A. The service has the authority under 620B prepare a substitute return and then ultimately make an assessment.

Q. So at some time if a return is not filed, they are going to be assessed with failing to not pay the tax in the nature of a deposit?

A. We have sufficient resources, and we are aware of them, that should happen.

* * *

By Mr. Glick:

Q. If notice was given in — I believe you understand — do you understand plaintiff's argument with respect to when they assert notice was given?

By Mr. Zlatkin:

A. To an extent.

Q. And, what do you foresee their argument as being?

A. I basically believe that they — they're taking the position that since the letter is dated in February of 1984 that the first required filing would be in March — March 15 of 1984, and that, in fact, would have to consider the months of January and February.

Q. And, would then — if that was the case, would one return have been required to be filed?

A. That's correct.

Q. So they would not have — even if that was the position, they still shouldn't have filed January and February returns?

A. They would not have had to file them individually.

Q. What was the net effect of this — of — to your knowledge, of the 7312 notification with respect to the filing of taxes and when those taxes were due?

A. My opinion is that it had no – it presented no hardship to the taxpayer corporation and if I can explain, I mean simply that they would be required to make deposits on a weekly basis based on the amount of their payroll in any light and that the conversion from filing from a quarterly to a monthly basis really didn't cause them a hardship and, in fact, managed to present the Government with some guarantee that sizeable liabilities could not be run up, with the service having no power to do anything until the end of the quarter. It was a safeguard.

Q. What was the date the – I believe you testified that the – if notice was given in March, that the return should have covered January, February and March; is that correct?

A. Correct.

Q. I believe you also testified that that return should have been filed April 15th or thereabouts; is that correct?

A. April 15th, 1984 if it was a legal day of business.

Q. If they were a quarterly filer, when would the return be filed?

A. April 30th, 1984 for the first quarter of 1984, 941.

Q. Were you monitoring this account during this period?

A. I was.

Q. To your knowledge, did the taxpayers make deposits?

A. Not to my knowledge.

Q. Did you receive any – did you receive the – do you recall receiving plaintiff's exhibit number one?

A. I recall receiving the exhibit.

Q. Were there any instructions onto what taxes this amount should have been applied to?

A. I believe there were.

Q. And, this – for this specific check?

A. Not on the check itself.

Q. Okay. Were there any instructions with respect to this specific check? How this specific check were to be applied? Do you know?

A: No instructions, at least on the check.

Q. Were there any – well, turning to plaintiff's exhibit number two, were there any instructions with respect to how this specific check were to be applied?

A. As stipulated on the check?

Q. Correct.

A. No, there were no instructions.

THE COURT: Well, you keep qualifying that. You're saying as stipulated on the check. As opposed to what?

A. As opposed to an accompanying letter.

THE COURT: Well, there was an accompanying letter?

A. As opposed to a stipulation entered into with a representative of the service and a representative of the American International Airways.

THE COURT: Well, were there these things? Were there letters or stipulations?

A. Yes, sir. Yes, there were.

THE COURT: There were? Why don't we have them?

Q. To clarify the record, was there . . .

MR. WINTERHALTER: It was stipulated. The application of the payments was stipulated.

MR. GLICK: Well, the application of the payments is stipulated, however . . .

THE COURT: Well, you're saying it is stipulated. Where is it stipulated?

MR. WINTERHALTER: Your Honor, in the stipulation of facts that was filed.

THE COURT: All right. Where?

MR. WINTERHALTER: Your Honor, . . .

MR. GLICK: Well, just to clarify what I am trying to get at, Your Honor, with respect to these, are there any – the stipulation, Your Honor, states that both checks are to be applied together. I was wondering if there were any instructions how each individual check was to be applied separately.

A. No, there were no instructions of that nature.

Q. So the only instructions were how they were both to be applied; is that correct?

A. That is correct.

THE COURT: Oh, all right. Yes, that is in the stipulation. All right.

A. May I clarify a point?

THE COURT: Yeah, go ahead. Any clarification would be helpful at this point. Yes, go ahead.

A. Originally, I was asked what was owned by American International Airways and I answered $15,000 was assessed. It is probably important to clarify the fact that a million five was owed with respect to accrued taxes that had not yet been assessed. The basis for these two payments was two-fold. Was to recover the delinquencies and the taxes that were accruing on a current basis as of the date of the submission, April 30th. So that the corporation had the opportunity to continue in business. That is the basis of this stipulation.

Q. Just to – I want to understand. You are saying that the check was to be applied to the current tax liabilities?

A. It was applied to – if my recollection is correct, to the

. . .

MR. GLICK: Well, Your Honor, I believe it has been stipulated to what the check has been applied at any rate.

A. It would be current through the April month. That was my understanding as to how the division of monies were to be applied in conjunction with what had already been run up.

Mr. Bruce Edmondson
As Chief Financial Officer
American International Airways Inc.
2655 Philmont Avenue
Huntingdon Valley, PA 19006

Alan D. Zlatkin

(215) 887-5751

C:ADZ:2337

Feb. 1984

Dear Mr. Edmondson:

Our records show that you have not paid over to the United States, at the time and in the manner prescribed by law and regulations, the taxes you were required to withhold from your employees.

Therefore, under the provisions of Section 7512 of the Internal Revenue Code, you are notified that effective for the month of March 1984 you must file Form 941 for the first quarter of 1984 by April 15, 1984 and for each subsequent month you must file Form 941-M by the 15th day of the month following the month covered by the return with the Revenue Officer named above.

In addition, our records show that you have not paid over to the United States, at the time and in the manner prescribed by law and regulations, the excise taxes for transportation of persons by air. Therefore, you must file Form 720 for the first quarter of 1984 by April 15, 1984 and for each subsequent month you must file Form 720 by the 15th day of the month following the month covered by the return with the Revenue Officer named above.

Form 2481 provides a detailed explanation of the responsibilities and procedures as they relate to depositing, filing, and payment for the Forms 941 and 720 monthly returns.

If you have any further questions, please contact the person whose name and telephone number are shown above.

Sincerely yours,

J. L. West
Chief, Collection Division

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re:	:	CHAPTER 11
AMERICAN INTERNATIONAL AIRWAYS, INC., Debtor	:	BANKRUPTCY NO. 84-02379K
HARRY P. BEGIER, JR., TRUSTEE, Plaintiff	:	
v.	:	
UNITED STATES OF AMERICA, INTERNAL REVENUE SERVICE, Defendant	:	
	:	ADVERSARY NO. 86-1076

STIPULATION

The Trustee, Harry P. Begier, Jr., by and through his counsel, CIARDI, FISHBONE & DiDONATO, and the United States of America, Department of Treasury, Internal Revenue Service, by its counsel, THE UNITED STATES DEPARTMENT OF JUSTICE, TAX DIVISION, hereby stipulate and agree as follows:

WHEREAS, on September 18, 1986, the Trustee filed a Complaint against the Internal Revenue Service seeking to avoid certain preferential payments made by the Debtor Corporation to the Service during the ninety (90) days preceding the bankruptcy filing;

WHEREAS, a trial was held on this complaint before this court on November 17, 1987;

WHEREAS, subsequent to the close of the trial, the Trustee discovered a document which was not considered at trial;

WHEREAS, the Trustee has filed a Motion to Open the Record to permit the introduction of this correspondence; and

WHEREAS, the parties, through their counsel, desire to mutually resolve this issue short of further argument and litigation;

NOW THEREFORE, it is hereby stipulated and agreed by between the parties that the letter from Alan D. Zlatkin to Bruce Edmondson dated May 1, 1984, a copy of which is attached as Exhibit "A", shall be admitted into evidence without objection and incorporated in the record of the proceeding, and further that all parties shall bear its own costs of this Motion.

FOR THE TRUSTEE:

CIARDI, FISHBONE & DiDONATO

By: _____
PAUL J. WINTERHALTER
1900 Spruce Street
Philadelphia, PA 19103

FOR THE UNITED STATES OF AMERICA,
DEPARTMENT OF TREASURY,
INTERNAL REVENUE SERVICE:

By: _____
STUART J. GLICK
Trial Attorney, Tax Division
U.S. DEPARTMENT OF JUSTICE
P.O. Box 227
Ben Franklin Station
Washington, DC 20044

APPROVED BY THE COURT THIS DAY OF , 1988.

By: _____
DAVID A. SCHOLL, U.S.B.J.

Internal Revenue Service **Department of Treasury**

District
Director
American International Airways Inc.
2655 Philmont Ave.
Huntingdon Valley, PA 19006

Attn.: Bruce Edmondson

Person to Contact:
A. D. Zlackin
Telephone Number:
(215) 877-5751
Refer Reply to:
C:ADZ:2337
Date: May 1, 1984

Dear Mr. Edmondson:

Thank you for your recent payment of $1,429,797.70. The payment was applied as follows:

1) 941-8401	259,992.98	–	Full payment
2) 941-8402	228,781.00	–	Full payment
3) 941-8403	105,765.68	–	Part payment
4) 720-8402	305,460.34	–	Full payment
5) 941-8404	300,000.00	–	Current Tax
6) 720-8404	299,797.71	–	Current Tax
			695,000.00
Total – $1,429,797.70			734,797.71
			1,429,797.71

Please note the credits applied for your April returns (941 and 720). They should be shown as deposits on each return. The division of the $529,797.71 designated to current taxes was purely speculative since you did not indicate the actual amounts that are due for April. I will anticipate full payment of the 941 and 720 for April 1984 on May 15, 1984 when you file the tax returns with me.

It is now the beginning of a new month. I will again remind you to make current deposits (for 941 and 720) in the special bank account as per the Notice 2481 issued to you. On May 15, 1984, I want you to present to this office proof of deposits. You will have to show me a payroll summary detailing the payrolls

and resultant tax for May 1 to May 15, 1984. You must also produce deposit slips indicating amounts deposited. Lastly, I want to see a statement of what is in this special account as of May 15, 1984. There must be complete compliance with the Notice 2481 requirements, or it will be necessary to recommend enforcement.

American International Airways Inc.

There are two assessed periods to be paid in full on May 31, 1984. They are:

1) 941-8403	274,342.90	plus penalty and interest
2) 720-8403	250,177.39	plus penalty and interest
TOTAL –	$524,520.29	plus penalty and interest

I will calculate the additional penalty and interest and send you a bill in advance of the 31st.

Please call me if you have any questions.

Respectfully,

A. D. Zlatkin
Revenue Officer

No. 89-393

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

HARRY P. BEGIER, JR., TRUSTEE,

Petitioner,

— v. —

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE

Respondent.

On Writ of Certiorari to the
United States Court of Appeals
For The Third Circuit

BRIEF FOR PETITIONER

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Counsel of Record

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QUESTION PRESENTED FOR REVIEW

Whether a debtor's pre-petition payment of funds from its general operating account for trust fund tax obligations excludes that property from the bankruptcy estate subject to avoidance as preferential transfers under §547 of the Bankruptcy Code?

LIST OF PARTIES TO THIS PROCEEDING

Your Petitioner in the instant proceeding is Harry P. Begier, Jr., the duly appointed Chapter 11 Bankruptcy Trustee in the Bankruptcy matter of American International Airways, Inc.[1] which proceeding was originally commenced in the United States Bankruptcy Court for the Eastern District of Pennsylvania under Case Number 84-02379K on July 19, 1984. The Respondent in this proceeding is the United States of America Internal Revenue Service.

1. American International Airways, Inc. is a wholly owned subsidiary of AIA Industries, Inc., both entities of which filed bankruptcy proceedings under Chapter 11 in July of 1984. AIA Industries, Inc. Bankruptcy was filed on July 23, 1984 under Case Number 84-02411.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

No. 89-393

IN THE

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— v. —

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE

Respondent.

On Writ of Certiorari to the
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For The Third Circuit

BRIEF FOR PETITIONER

OFFICIAL CITATION TO DECISIONS BELOW

Harry P. Begier, Jr., Trustee v. United States of America, Internal Revenue Service, Appellant, 878 F.2d 762 (3rd Cir. June 30 1989, *as amended* July 13, 1989, *rehearing denied* July 28, 1989), 38 U.S.L.W. 2032, 89-2 U.S.T.C. Page 9416. The Oral Opinion of the District Court is unreported but appears beginning at Page A-22 of the Petitioner's Appendix to the Petition for Writ of Certiorari. The Opinion of the Bankruptcy Court is reported at 83 B.R. 324 (Bkrtcy. E.D. Pa 1987) and also appears in the Appendix to the Petition for Writ of Certiorari beginning at Page A-27.

STATEMENT OF JURISDICTION

Your Petitioner appeals from the Opinion and Order of the United States Court of Appeals for the Third Circuit filed on June 30, 1989 and as amended on July 13, 1989. A Petition for Rehearing pursuant to Federal Rule of Appellate Procedure 40(a) and Suggestion for Rehearing en banc was denied by the Third Circuit by Order dated July 28, 1989.

Original jurisdiction for the proceeding in the Bankruptcy Court was founded on 28 U.S.C. Section 1334(b) and 28 U.S.C. Section 157(b)(2)(F). Appellate review by the District Court was based on 28 U.S.C. Section 158(a) and by the United States Court of Appeals for the Third Circuit pursuant to 28 U.S.C. Section 158(d) and Section 1291. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1) based on this Court's granting a Petition for Certiorari on January 8, 1990. *Begier v. United States of America Internal Revenue Service*,____U.S.____, 110 S.Ct. 714 (1990).

STATUTES AT ISSUE

Section 547 PREFERENCES

(a) In this Section –

* * *

(4) a debt for a tax is incurred on the day when such tax is last payable, including any extension, without penalty.

(b) except as provided in Subsection (c) of this Section, the Trustee may avoid any transfer of property of the Debtor–

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the Debtor before such transfer was made;

(3) made while the Debtor was insolvent;

(4) made–

(a) on or within ninety (90) days before the date of filing the Petition; or

(b) between ninety days and one year before the date of filing of the Petition, if such creditor at the time of such transfer–

(i) was an insider; and

(ii) had reasonable cause to believe the Debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such creditor would receive if–

(a) the case were a case under Chapter 7 of this title;

(b) the transfer had not been made; and

(c) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. Section 547(b) (1982).[2]

Section 541 PROPERTY OF THE ESTATE

(a) The commencement of a case under Section 310, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

* * *

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2. As noted by the Court of Appeals in their decision in the instant case, 11 U.S.C. Section 547(b) was amended in 1984, although the earlier version as originally enacted is applicable to this case. Public Law No. 98-353, Title III, Sections 310, 462 July 10, 1984, 98 Stat. 355, 378 was made applicable only to cases commenced ninety days following enactment. Since this case was filed on July 19, 1984, the 1982 provisions of the Bankruptcy Code applies. *Begier v. United States*, 872 F.2d 762, 765 (3rd. Cir. 1989) (Appearing at Page 6 of Official Opinion.)

(7) Any interest in property that the estate acquires after the commencement of the case.

* * *

(d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

11 U.S.C. Section 541. (1982)

SECTION 7501. LIABILITY FOR TAXES WITHHELD OR COLLECTED.

(a) General rule.

Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

26 U.S.C. Section 7501 (1984).

STATEMENT OF CASE

Your Petitioner has requested that this Court review a Decision rendered by the United States Court of Appeals for the Third Circuit which reversed a Decision of the United States District Court affirming a Final Order of the United States Bankruptcy Court. The Petitioner herein is the Court appointed

Chapter 11 Bankruptcy Trustee in the matter of American International Airways, Inc., which proceeding is pending in the United States Bankruptcy Court for the Eastern District of Pennsylvania.[3] The original action at issue before this Court was commenced by the Trustee seeking to avoid four payments made during the ninety (90) days preceding the bankruptcy filing by the Debtor Corporation, hereinafter referred to as "Debtor" to the Internal Revenue Service, hereinafter referred to as "IRS" as preferential transfers pursuant to 11 U.S.C. Section 547 (b).

The facts critical to the matter were never in dispute and were largely established before the Bankruptcy Court by a Stipulation of facts submitted by the parties and made a part of the record at trial.[4] Additionally, the Bankruptcy Court made specific findings of fact which were expressly incorporated in the Bankruptcy Court Opinion.[5]

The Debtor was a commercial airline that provided passenger and air cargo service to the Eastern and Central United States. (J.A.p.A-21). As a regular employer of individual taxpayers, the Debtor was required to withhold and pay on a quarterly basis certain employment taxes, specifically the employee's share of withholding taxes and the employee's share of Federal Insurance Compensation Act taxes. (J.A.p.A-29-31). The Debtor was also required to pay the employer's share of the FICA assessment. Additionally, as an airline carrier, the Debtor was subject to certain Federal Excise taxes collected from airline passengers. These taxes were all required to be paid by the Debtor to the IRS. (J.A.P.A-30).

By the first quarter of 1984, the Debtor had become delinquent in the filing and the payment of its Social Security,

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3. A Chapter 11 Liquidating Plan has been confirmed by the Bankruptcy Court by Order dated November 3, 1988. Under the Plan the Trustee is responsible to liquidate all assets of the estate, including the claim involved in this suit.

4. A copy of the Stipulation admitted into the record before the Bankruptcy Court (J.A.p.A-21) and was duplicated in the Appendix to the Writ of Certiorari beginning at Page A-46.

5. *Begier v. IRS*, 83 B.R., 324, 326-7 (Bkrtcy. E.D. Pa. 1987).

Federal Income and Excise taxes in an amount which approximated One Million Five Hundred Thousand Dollars ($1,500,000). (J.A. P.A-44) As a direct result of the poor filing and payment history of the Debtor, including its inability to make timely tax deposits of withholding obligations, the IRS issued a notice pursuant to 26 U.S.C. Section 7512 requiring the debtor to file its employer tax return on a monthly basis. The IRS further required the Debtor to establish a special account for future deposit of all tax obligations. These notices were delivered by mail on February 22, 1984 and personally served upon a principal of the Debtor on March 1, 1984. (J.A. P.A-24,39).

In response to the notices, the Debtor established a specially designated tax account on March 6, 1984 and deposited sums therein on March 22, March 30, April 13, and April 17, 1984 totalling Six Hundred Ninety-Five Thousand Fifty-One Dollars and Forty Two Cents ($695,051.42). (J.A. P.A-35) From this designated account, the Debtor on April 30, 1984 transferred Six Hundred Ninety-Five Thousand Dollars ($695,000) directly to the IRS. (J.A. P.A-22,35) This payment was accompanied by a check from the Debtor's general operating account in the amount of Seven Hundred Thirty-Four Thousand Seven Hundred Ninety-Seven Dollars ($734,797). These payments were transmitted with a letter from the Debtor specifically directing the application of the monies to varying tax obligations for specific periods. (J.A. P.A-33). The application of these monies as directed by the Debtor was subsequently confirmed by the Revenue Officer of the IRS responsible for the delinquent entity. (J.A. P.A-48).

Additional transfers were paid out of the Debtor's general operating account by check dated June 22, 1984 in the amount of Two Hundred Thousand Dollars ($200,000) and then subsequently by check dated June 24, 1984 in the amount of Eleven Thousand Six Hundred Thirty-Six Dollars and thirty five cents ($11,636.35). (J.A. P.A-23,37). On each subsequent occasion the delivery of the payments was accompanied with a specific direction from the Debtor designating the application of the payment to specific taxes due. (J.A. P.A-43).

As a result of continuing financial problems, the Corporation was required to file for bankruptcy relief under Chapter 11 of Title 11 of the United States Code on July 19, 1984. 11 U.S.C. §1101 *et seq.* (1982). In the early stages of the bankruptcy the debtor remained in business as a debtor-in-possession. The Debtor, however, was unable to operate profitably in the bankruptcy whereby, your Petitioner herein was appointed by the Bankruptcy Court on September 19, 1984 to serve as the Chapter 11 Trustee. *Begier v. IRS*, 83 B.R. at 325 (citing to a previous decision in the same bankruptcy). *See In re American International Airways, Inc.*, 74 B.R. 691, 692-3 (Bkrtcy. E.D. Pa. 1987).

The Trustee, during the administration of the bankruptcy proceeding, instituted this action against the Internal Revenue Service seeking to avoid the three transfers from the Debtor's general operating account as preferential payments under §547 of the Bankruptcy Code.[6] Following a trial on the merits and in full consideration of the Stipulation the parties submitted previously thereto, the Bankruptcy Court found the Trustee entitled to avoid Seven Hundred Thousand, Four Hundred Ten Dollars ($700,410) as preferential transfers made by the Debtor to the IRS. *Begier v. United States Internal Revenue Service*, 83 B.R. 324, 333 (Bkrtcy. E.D. Pa. 1988).

Based on the facts as stipulated, the IRS acknowledged before the Bankruptcy Court that the Trustee had established the requisite elements for avoidability under 547(b). The IRS unsuccessfully argued, however, that the three transfers at issue should be excepted from avoidance pursuant to a certain affirmative defense included in the statute under Section 547(c)(2). The Bankruptcy Court ruled that the IRS failed to carry its affirmative burden in establishing each element of the defense

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6. The original complaint alleged as preferences only the three transfers from the debtor's general operating account. (J.A. P.A-14). In order to contest certain affirmative defenses raised by IRS, the complaint, by stipulation, was amended to include the fourth transfer of $695,000 from the specially designated trust account. Petitioner never suggested this specific transfer was avoidable. (App. to Petition for Writ of Certiorari P. A-46).

and granted judgment in favor of the Trustee. *Id.* at 328, 333. The Bankruptcy Court decision was affirmed by the District Court in an unreported decision. *Begier v. United States Internal Revenue Service,* No. 88-3529 (E.D. Pa. August 15, 1988) (Donald W. VanArtsdalen, J.).

On Appeal to the Third Circuit Court of Appeals, the IRS changed its tactics. The Government relinquished its argument regarding the affirmative defense and instead pursued an issue which originally was summarily rejected by the Bankruptcy Court. The IRS argued, by operation of law, a statutory trust imposed under the Internal Revenue Code in Section 7501 should take precedent over the Bankruptcy Code whereby any payment for the trust fund portion of withholding taxes to the government, regardless of the source, removed the property from being considered part of the Debtor's estate thereby precluding avoidability.[7]

The Third Circuit approached this issue the same as have several Courts who have had an opportunity to address the argument. The Court found the terms included in the preference statute to be lacking clear directive and therefore looked to the legislative history for the Congressional intent behind the statute. *Begier v. United States,* 878 F.2d 762, 766 (3rd Cir. 1989) (Cert. App. P. A-9). The majority Opinion of The Third Circuit adopted the rationale set forth by the dissenting Opinion of the Honorable Ruth Ginsburg in *Drabkin v. District of Columbia* 824 F.2d 1102 (D.C. Cir. 1987). *Id.* at P. 771 (Cert.

7. Section 547(b) of the Bankruptcy Code requires that a Trustee may only avoid transfers which are the property of the debtor. 11 U.S.C. Section 547(b)(1982). As noted in the Third Circuit's Opinion "the Bankruptcy Code does not define the phrase "property of the debtor" found in §547(b). Therefore, courts have looked to whether the transferred property may be defined as "property of the estate" under §541. Indeed, to constitute a preference under §547(b), a transfer must deprive the debtor's estate of property that could otherwise be used to satisfy creditors. *In re Newcomb,* 744 F.2d 621, 626 (8th Cir. 1984); *see also* 4 *Colliers on Bankruptcy* Paragraph 547.03[2] (1989) ("A transfer is preferential only if the property or the interest in property transferred belongs to the debtor . . . The fundamental inquiry is whether the transfer diminished or depleted the debtor's estate")." *Begier, supra.* 878 F.2d at 769. (Footnote 13).

App. P. A-19) The majority concluded that certain wording in the legislative history mandated special treatment for withholding taxes. While the Court acknowledged that the Internal Revenue Service would not be able to sidestep the Trustee's power to avoid non-trust fund payments such as corporate income taxes, federal unemployment taxes or the employer's share of FICA taxes, it found the ability of the Debtor to make a pre-petition payment on account of withholding taxes, regardless of the source of the funds used to make the payment, impressed with trust characteristics removing the property from the Debtor's estate. *Begier v. United States,* 878 FD.2d 762, 763, 771 (3rd Cir. 1989).

The Third Circuit thereon directed the instant case be remanded to the District Court for findings consistent with the Court's ruling. Upon the entry of the Order, your Petitioner timely filed a Petition for Rehearing pursuant to Federal Rule of Appellate Procedure 40(a) and a Suggestion for Rehearing *en Banc* pursuant to Federal Rule of Appellate Procedure 35(a). Both the Petition for Rehearing and Rehearing *en Banc* were denied by the Court by Order dated July 28, 1989. A Petition for Writ of Certiorari was timely filed with this Court, whereon January 8, 1990 the Petition was granted. *Begier v. United States,* ____U.S.____, 110 S. Ct. 714, (1990).

SUMMARY OF ARGUMENT

Your Petitioner is a Trustee in bankruptcy which sought to avoid three transfers from a debtor's general operating account to the IRS in satisfaction of outstanding trust fund taxes as voidable preferences under §547(b) of the Bankruptcy Code. The IRS argues that the payments are not voidable because monies paid to the IRS are covered by a statutory trust under 26 U.S.C. §7501 which effectively removes these payments from being considered property of the estate. A panel of the United States Court of Appeals for the Third Circuit, in a majority Opinion relied principally on statements originally set out in the Dissenting Opinion by the Honorable Ruth B. Ginsburg in the case of *Drabkin v. District of Columbia,* 824 F.2d 1102,

1117-1120 (D.C. Cir. 1987) in concluding that the transfers at issue were subject to a trust thereby precluding avoidability. Based on the arguments summarized below, the Third Circuit holding is incorrect and should be reversed.

The basis for reversal is fourfold. First, the Court below relies on the wrong Legislative History to the statute as actually enacted. The Legislative History expressly referred to in both the Majority Opinion by the Third Circuit and the Dissenting Opinion in Drabkin explained a section of a proposed statute which was never enacted by Congress. The specific sections which the cited History referred were expressly omitted from the amended legislation as finally enacted. Reliance on this Legislative History, which is the cornerstone to the Majority's holding, is without merit.

Secondly, the Majority fails to consider critical facts of record before the Trial Court. The Majority presumes the monies subjected to the alleged trust were collected and withheld from employees' wages. The record, however, reflects that no monies were withheld. The statute relied upon to establish a trust, 26 U.S.C. §7501 is written in the past tense, imposing the trust on funds actually collected and withheld. The failure to pay the monies into an established tax depository bars the creation of the trust mandated by §7501 because the physical act, collection and withholding, was never accomplished. This rationale has recently been approved by a third Circuit Court to address the exact issue. *United States v. Daniel,* 887 F.2d 981 (9th Cir. 1989).

The holding by the Majority Panel is also contrary to prior principles established by this Court. Previously, this Court ruled that for a trust under §7501 to exist, the IRS must trace funds to the perceived trust. *United States v. Randall,* 401 U.S. 513, 91 S. Ct. 991 (1971). While Congress, in enacting the Bankruptcy Code of 1978, may have relaxed the tracing requirements to permit the use of reasonable assumptions when the IRS is unable to strictly trace funds into a trust, the statute as enacted and the Legislative History is silent as to any effect on pre-petition payments. The majority suggests this silence represents Congressional intent to preclude the necessity of the IRS

tracing to establish the existence of pre-petition trusts. Such logic is nonsensical. The principles preserved by this Court's Opinion in *Randall* and its progeny regarding the establishment of trust under §7501 of the Internal Revenue Code are equally applicable for the avoidance of pre-petition transfers.

Finally, the holding of the Third Circuit is contrary to the established principles of the Bankruptcy Code including its ability to assure equality of distribution to all creditors similarly situated. The preference statute under the Code is a vehicle to preserve and enforce those bankruptcy principles. The Majority's ruling emasculates those principles by granting to the IRS a preferred status not expressed in the plain wording of the statute. For these reasons, the Third Circuit holding must be reversed.

ARGUMENT

PAYMENTS TO THE INTERNAL REVENUE SERVICE FROM THE GENERAL OPERATING ACCOUNT OF A DEBTOR OVER WHICH DISBURSEMENTS THE DEBTOR HAD CONTROL AND WHICH FUNDS WERE NOT WITHHELD FROM EMPLOYEE WAGES ARE TRANSFERS OF PROPERTY OF THE DEBTOR AVOIDABLE UNDER 11 U.S.C. §547(b) AND NOT IMPRESSED WITH A TRUST PURSUANT TO 26 U.S.C. §7501.

This case presents for this Court's review the issue of whether a trustee in bankruptcy may avoid as preferential transfers pursuant to 11 U.S.C. §547(b) monies paid on account of trust fund taxes to the IRS prior to the filing of the bankruptcy proceeding. The IRS successfully argued before a Third Circuit Panel that 26 U.S.C. §7501 (1984) of the Internal Revenue Code impresses any monies paid prior to the bankruptcy filing with a trust which, solely by operation of law, removes this money from being considered property of a bankrupt estate subject to avoidance. The Majority agreed with the IRS argument, reversed the decisions of the District Court and the Bankruptcy Court and relied predominantly on the rationale originally set forth in the Dissenting Opinion by the United States Court of

Appeals for the D.C. Circuit in *Drabkin v. District of Columbia. Drabkin, supra.*

It is respectfully presented that the Majority Opinion written by Judge Scirica for the Third Circuit and the theories espoused by Judge Ruth Ginsburg in her Dissent in *Drabkin* are legally incorrect. The Third Circuit errs in its recitation of the law. Judge Scirica's conclusions are based on legislative history which addressed a proposed statute not enacted, presumes facts that do not appear in the record and fails to give clear interpretation to the plain meaning of both §547 of the Bankruptcy Code and §7501 of the Internal Revenue Code. The Circuit Court's holding incorrectly distinguishes the effect of prior rulings of this Court whose legal principles should be applicable to the case at bar. This Brief will analyze each of these points and respectfully request, based on these errors in the interpretation of the law, that this Court reverse the Decision of the United States Court of Appeals for the Third Circuit.

A. The Decision of the Court of Appeals for the Third Circuit is Based on Legislative History of a Proposed Statute Not Enacted by Congress.

Several Courts have attempted to interpret whether Congress intended, when enacting the Bankruptcy Code, to permit a bankruptcy trustee to avoid pre-petition transfers on account of taxes paid to a governmental authority which if properly withheld would be covered by a statutory trust.[8] Each of the Courts,

8. In addition to the diametrically opposed conclusions of the D.C. Circuit in *Drabkin, supra.* and the Third Circuit in *Begier, supra.*, the Ninth Circuit in the case of *United States v. Daniel*, 887 F.2d 981 (9th Cir. 1989) has entered the arena to tip the Circuit scales in favor of reversal. The Third Circuit acknowledged the separate views of varying Bankruptcy Courts. *Begier, supra.* at 767 citing to *In re: Rodriquez*, 50 B.R. 576 (Bkrtcy. E.D. NY 1985) and *In re: Razorback Ready-Mix Concrete Company*, 45 B.R. 917 (Bkrtcy. E.D. Ark 1984) with *In re: Olympic Foundry Company*, 63 B.R. 324 (Bkrtcy. W.D. Wash 1986), rev'd on other grounds, 71 B.R. 216 (9th Cir. BAP 1987) and *In re: Miller's Auto Supplies, Inc.*, 75 B.R. 676, 679-81 (Bkrtcy E.D. Pa 1987). The majority in *Drabkin, supra.* at 1110 carefully recognized the divergent views of the Bankruptcy Courts. *See*, in particular Footnotes 27 and 28 in *Drabkin, Id.*

however, have concluded that the statute on its face does not provide clear direction to resolve the issue whereby they have referred, at least in part, to the legislative history supporting the enactment of the Bankruptcy Reform Act of 1978 for guidance.[9]

In the case before this Court, the Third Circuit followed the same procedure. The Court cited to the legislative history to support its conclusion that a pre-petition payment may not be avoided in light of the protections afforded the Internal Revenue Service under 26 U.S.C. §7501. The Majority quoted excerpts from the Senate Report of July 14, 1978 and the House Report issued September 8, 1977 to support its conclusion of what Congress intended by the statute. *Begier,* 878 F.2d at 767 (*citing to* H.R. Rep. No. 595, 95th Cong. 1st session 373 reprinted in 1978 U.S. Code Cong and Administrative News 5787, 6329. The Third Circuit majority also acknowledged the identical issue was squarely addressed by the D.C. Circuit in *Drabkin, supra., Id.* The Third Circuit noted the Dissent in *Drabkin* relied on the exact provision of the House Report which it reprinted at length, in its own Opinion. *Begier, supra.* at 768 citing to *Drabkin,* 824 F.2d at 1117 (Ruth B. Ginsburg, J. Dissenting)[10]. The Court believed the portion of the House Report to express the intent of Congress to preclude the avoidability of tax withholding payments.

While acknowledging that the Majority in *Drabkin* attempted to discount this passage by referring to other language in the House Report, the Third Circuit concluded, as did the Dissent in *Drabkin,* that the fact that a party is able to make the

9. Act of November 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549, hereinafter referred to as the Bankruptcy Code or The Bankruptcy Reform Act of 1978.

10. The segment from the House Report as quoted read:

> A payment of withholding taxes constitutes a payment of money held in trust under Internal Revenue Code §7501(a) and thus will not be a preference because of the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payment.

1978 U.S. Code and Administrative News at 6329.

payment alone is sufficient to establish the trust under 26 U.S.C. §7501. Judge Ruth Ginsburg noted that "while the Report might have been phrased more mellifluously, what it sought to convey comes across without static: if the debtor is able to make the payment, the taxes 'have been properly held for payment,' which places the trust beneficiary in a class separate from other creditors and thus removes this payment from the category of preferences voidable by the trustee." *Drabkin, supra.* at P. 1118.

The problem with this approach adopted by both the Third Circuit and Judge Ginsburg in Dissent of *Drabkin* is the language contained in the House Report to House Resolution 8200 as quoted and relied upon by both Courts referred to a prior draft of proposed legislation rather than the Bankruptcy Code as finally enacted by Congress. As recognized by Judge Douglas Ginsburg in writing for the Majority in *Drabkin,* the ultimate wording of the Bankruptcy Reform Act for §541 and §547 represented a compromise between competing pieces of legislation introduced in the House of Representatives and the Senate. *Drabkin,* 824 F.2d at 1106. The Court carefully traced the Legislative revisions through different drafts of the statute.

In its earlier drafts, the House sponsored legislation afforded no special treatment to either withheld taxes or to pre-petition tax payments, but as the accompanying House Report indicated, these general provisions would have nonetheless protected the interest of taxing authorities. *Drabkin, supra.* at 1107. As further analyzed by Judge Douglas Ginsburg:

> The House Bill was then sent to the Senate, which had been drafting its own legislation (footnote omitted). Instead of simply amending House Resolution 8200 to conform to that legislation, the Senate passed its own bill (S. 2266) and substituted it for the House version. Unlike the House, the Senate specifically protected taxing authorities. Section 541(b)(3) of the Senate Bill would have excluded from the debtor's estate any "taxes withheld or collected from others

> pursuant to federal, state, or local law before the commencement of a case and required to be paid to a government unit."

Drabkin, supra. at p. 1108.

Specifically, as Judge Drabkin further noted the bill as then proposed by the Senate contained the express provision that:

> The Trustee may avoid any transfer of property of the debtor . . . for or on account of an antecedent debt, other than a debt which payment is required under the revenue laws of a government unit owed by the debtor before such transfer was made.

Drabkin, supra. at Page 1108.[11]

The legislation was then sent back to the House for consideration. The House did not approve of the Senate's proposed changes. The Senate insisted on its own version of the proposed legislation and requested a conference with the House. *Klee, Legislative History of the New Bankruptcy Law,* 28 DePaul L. Rev. 941, 953 (1979). Because of the lateness of the conference request in the legislative term, proponents of each version of the legislation met and agreed to resolve the differences between the two versions of the bill without a formal conference.[12] Intensive negotiations ensued. Klee, *supra.* at

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11. Judge Douglas Ginsburg actually provides a simplified analysis of the legislative history to the Bankruptcy Reform Act. Kenneth N. Klee provides a scholarly analysis of the legislative history behind the eventual enactment of the Bankruptcy Code including a careful examination of the political jousting which occurred to assure the passage of the major legislation during the waning hours of the 95th Congress. Klee, *Legislative History of the New Bankruptcy Law*, 28 DePaul L. Rev. Page 941 (1979). As noted by Judge Ginsburg in a footnote to the Majority Opinion, the House and Senate Committee Leaders took turns amending the legislation rather than sending their separate bills to a Conference Committee, *Drabkin, supra.*, P. 1108, footnote 20, referring to 124 Cong. Rec. 32392 (Sept. 28, 1978) (statement of Representative Edwards); 124 Cong. Rec. 33990 (Oct. 5, 1978) (statement of Senator DeConcini).

12. Klee, *Legislative History*, 28 DePaul L. Rev. at 954. Citing to 124 Cong. Rec. H 11,089 (daily ed. Sept. 28, 1978) (Remarks of Rep. Edwards). As Klee notes there were substantial disputes between the two versions. The principal differences involved the status of the Court and administrative

954-7. A compromise bill was eventually worked out by the Senate and House Floor Managers.

In the final amendments, substantial changes were made to the preference section as it pertained to the avoidability of taxes. The Managers adopted the House versions of §541 and §547 rejecting the alternative language contained in the Senate Bill. *Drabkin, supra.* The Managers also added a new subsection, §547(a)(4) which established when a debt for a tax is incurred.[13]

A Joint Explanatory Statement was issued with the compromised Legislation, given by Senator DeConcini and Representative Edwards before their respective bodies. As Judge Ginsburg for the Drabkin Majority noted, these Joint Statements clearly reflected that the language precluding avoidability of tax withholding payments as contained in the former Senate Bill was expressly not enacted. *Id.* This point is further evidenced by the amendment's change to contrary language in the earlier House and Senate Reports so that it was clearly indicated that the government would be subject to avoidance of preferential transfers and that 11 U.S.C. §106(c) (the sovereign immunity protections) would not apply. *Drabkin, supra.* at P. 1109.

The critical effect, however, of the compromise legislation is that the portion of the House Report expressly relied upon by the Third Circuit and Judge Ginsburg in Dissent in Drabkin referred to language in a proposed statute that was expressly

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systems, being whether the Bankruptcy Courts should be Article III Courts or as adjuncts to the United States District Courts. There were significant differences in substantive law as well, including issues such as exemptions, reaffirmation and the treatment of public companies in reoganization cases. *Klee, id.* at 953. As Kenneth Klee recounts, the revised Bankruptcy Code was ten years in the offing, endured hundreds of amendments, received comments for many legal scholars through Congressional solicitation, was rewritten and revised on countless occasions, only to be subjected to the legislative crunch at the end of the 95th Congress. Without its adoption in the then current term, the process would have to begun anew in the 96th Congress in 1979. Klee, *Id.*

13. In the definition section, the Managers added a fourth definition. The subsection provided that "(4) A debt for a tax is incurred on the day when such tax is last payable, including any extension, without penalty." 11 U.S.C. §547(a)(4) (1982).

omitted from the final bill. Reliance on this language which is the cornerstone to the Majority's holding below is without merit. Congress simply did not intend what the Majority in *Begier* suggests. The Courts by referring to the wrong Legislative History support an invisible statute. The language which was referenced does not appear in the final enacted text of §547.[14]

B. Where the Plain Language of the Statute Permits a Conclusive Analysis, it is Unnecessary to Reply on Materials Outside the Statutory Text to Interpret the Statute.

Further argument against the Third Circuit's holding is evidenced from a plain reading of the Statutes at issue. This Court has favored giving plain meaning to statutory text. *United States v. Ron Pair Enterprises, Inc.*, 489 U.S.____, 109 S. Ct. 1026, 1031 (1989). The judicial task is to interpret laws rather than reconstruct legislators' intentions. It must be assumed what Members of the House and Senators thought they were voting for, and what the President thought he was approving when he signed the Bill, was what the text plainly said, rather than what a few representatives, or a community reports said it said. *United States v. Taylor*, 487 U.S. 326, 108 S. Ct. 2413 (1988) (J. Scalia concurring in part). While there is no reason to proceed otherwise in this case the Third Circuit's holding does.

Section 547 of the Bankruptcy Code does not expressly preclude the avoidability of all tax payments. This is evidenced by the statute plainly describing when a tax is due in §547(a) and

14. The effect of the Majority and Judge Ginsburg's Dissent in *Drabkin* is to preclude the avoidability by a bankruptcy trustee of any pre-petition trust fund tax payment. The Court suggests no tracing is required. A logical extension of this proposition will cause an absurd result. Presume the situation of where a bank lends money to a corporation for the purchase of inventory or equipment and the funds are in turn paid to or seized pre-petition by the IRS. Certainly there is no connection to employees wages but the Majority would believe these funds, because the payment was made to the IRS, to be impressed with a statutory trust under 26 U.S.C. §7501 and thus immune from avoidability. Such an overreaching effect could not have been the intent of Congress.

further excepting from avoidance the fixing of a statutory lien in §547(c)(6). The IRS admits and the Third Circuit concurs that for certain taxes, avoidability of tax payments is possible. The Third Circuit noted its holding would not preclude the avoidability of non-trust fund taxes such as corporate income taxes, the employer's share of federal insurance contribution taxes and federal unemployment taxes. *Begier*, 878 F.2d at 771. The Third Circuit holds however that the statute does not permit the avoidance of trust fund taxes. *Begier, supra*. at Page 770. If this were true, why would not Congress have placed such an important provision in the statute?

As the Majority in *Drabkin, supra*. postulates, Congress was aware of the situation and in fact had included such language in the Senate Bill. *Drabkin*, 824 F.2d at Page 1108. The law as finally enacted, however, specifically omitted this preclusion. *Drabkin, supra*., at 109. The Majority's reliance on the Reports explaining the unenacted provision should not be used to resurrect words which have been buried. When the language of the law is clear, the Court should not replace it with unenacted intent. *INS v. Cardoza-Fonseca*, 480 U.S. 421 107 S. Ct. 1207 (1987) (J. Scalia concurring). If Congress desired to restrict avoidance of pre-petition tax withholding payments, it could and should have expressly stated such in the statute as enacted. The fact that it considered this restriction, as evidenced by the proposed Senate legislation but intentionally omitted, such plain wording may only mean that they did not intend to preclude the avoidability of trust fund tax payments. The plain wording of §547 mandates a conclusion opposite that reached by the Third Circuit.

A similar argument may be made for interpreting §7501 of the Internal Revenue Code. The IRS argued before the Court below that §7501 of the Internal Revenue Code may be used to remove property from the estate by the creation of a statutory trust. The IRS suggests and the Majority of the Third Circuit by their holding ruled that this special treatment arises solely by operation of law. The holding suggests that no proof of the trust's existence need be established, at least in the pre-petition transfer situation. *Begier, supra.* The IRS argument and the

holding by the Court fails to two counts. First, it ignores the plain language of §7501 requiring that for the trust to be created, the act of withholding must have occurred. Secondly, it creates an unrealistic extrapolation from prior rulings of this Court interpreting the trust statute of the Internal Revenue Code.

A proper reading of 26 U.S.C. §7501 required that a trust is deemed to exist if the taxes were in fact segregated by the person requiring to collect the tax under various statutes. The section expressly provides:

> Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax *so collected or withheld* shall be held in a special fund in trust for the United States (emphasis added).

26 U.S.C. §7501(a)

The language is specifically written in the past tense, meaning the act of withholding must have occurred. *See United States v. Slodov*, 436 U.S. 238 98 S. Ct. 1778, 56 L. Ed. 2d 251 (1978). The Majority Opinion by the Third Circuit presumes the money subject to the trust statute was withheld. This is an erroneous factual conclusion by the Majority. The Court repeatedly refers to withheld taxes, but nowhere in the record established in the Bankruptcy Court was there evidence that the monies where in fact withheld. To the contrary, the record reflects the monies were not collected. The witness on behalf of IRS testified in the trial court that while the returns for taxes were timely filed, those returns clearly showed that no tax deposits were made. (J.A. P.A-39,40)[15]

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15. The Government's witness Alan Zlatkin testified that the debtor did not make the deposits (J.A.39,40). The record also established when this trust should have been created. George L. Miller, the trustee's accountant testified that based on the amount of wages paid by the debtor, the IRS regulations required this taxpayer to deposit monies withheld into a Federal Reserve Institution for an amount equal to the required withholding three days following end of the pay period. (J.A. P.A-29,30). *See*, 26 C.F.R. §31.6302-1. The IRS suggests that segregation of funds is not required under the Internal Revenue Code. (Brief of Appellant to Third Circuit at Page 9). Such a

In *United States v. Slodov*, this Court ruled that a trust under 26 U.S.C. §7501 cannot be impressed on after acquired funds. *United States v. Slodov, supra.* The Supreme Court found that "under §7501, there must be a nexus between the funds collected and the trust created. That construction is consistent with the accepted principle of trust law requiring tracing of misappropriated trust funds into the trustee's estate in order for an impressed trust to arise. See *Dobbs, Handbook on Law of Remedies*, 424-425 (1973). *Id.* As all too often happens when a debtor corporation begins its slide into bankruptcy, the trust res in the tax scenario is not created. The employer funds only the net payroll for the benefit of his employees. The tax obligations, both the employee and employer share, is then perceived to be a problem to be dealt with at a later date. No sums are funded to create the trust res whereby the physical act, "the amount so collected or withheld" as contemplated in 26 U.S.C. §7501, never occurs. It therefore follows that the trust never existed. An interest which has not existed cannot be held in trust. *Restatement of Trust*, Volume I §75. The statute, by its own terms does not impose a trust on funds "collected *or which should have been collected*." The Government's argument imputes this additional wording into the Statute.[16] If this wording

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suggestion is completely contrary to the above referenced regulation. Unless the IRS is now suggesting that the regulations be disregarded, the procedures as described in the record should have been followed. In reliance on this record, the Bankruptcy Court concluded that no trust existed. *Begier v. United States Internal Revenue Service*, 83 B.R. at p.331.

16. Congress was cognizant of the employer taxpayer who fails to withhold income taxes from employee's wages. When enacting the priority section of the Bankruptcy Code (§507) the Court specifically considered giving a higher priority to employment taxes withheld or which should have been withheld than the priority given to an excise tax. See *In re Taylor Tobacco Enterprises, Inc.*, 106 B.R. 441, 442-4 (E.D. N.C. 1989). Of relevance here, the Court noted §507(a)(7)(c) granted a higher priority to taxes *required to be collected or withheld* (emphasis added) *id.* at 442. Nothing precluded Congress from placing the same language into §7501 of the Internal Revenue Code.

were what Congress truly intended, the language could have been expressly stated in the statute.[17]

The failure to pay these monies into the established tax depository as presented in the record below precludes the imposition of the trust which is mandated by §7501 because the act, collection and withholding, was never accomplished. No monies were taken from the employee's wages and deposited into the operating account. No trust res was ever created. The Majority simply failed to address this point.

C. The Decision of the Third Circuit is Contrary to the Established Principles Formerly Set Out by this Court.

The Third Circuit Majority also concludes that earlier rulings of this Court can be distinguished. The Third Circuit believed the ruling in *United States v. Randall*, 401 U.S. 513, 91 S.Ct. 991 (1971) and its progeny requiring a tracing by the IRS to establish the existence of a trust should apply only when the IRS is attempting to establish a trust on funds held by a debtor as of the commencement of the case. It is respectfully presented, however, that this unsupported rationale is incorrect. There is no reason why the principles preserved and protected by the *Randall* holding should not equally protect the same principles that exist under §547.

While this Court has never had the opportunity to address whether a Trustee in Bankruptcy may under Section 547(b) of

17. The District Court for the Southern District of Georgia, by District Judge Coolidge has adopted this theory. In an unreported opinion, the District Court distinguished *Randall*, discussed *infra*, acknowledging the required element to deposit taxes into a trust account. Judge Coolidge perceived significant point in *Randall* was that the taxes in fact were not deposited into a trust bank account, hence, no trust was actually created. In the case before his Honor, the withheld taxes were in fact deposited into a trust account which should then be impressed with the statutory provision as an explicit trust. *In re: Glynn Wholesale Building Materials, Inc.*, 1978 W.L. 1229 (S.D. Ga.), 78-1 U.S.T.C. Page 9469 (April 12, 1978). The act of withholding had been accomplished, thus the trust res had been created. In the case at bar the act of withholding was not accomplished, thus no trust exists.

the Bankruptcy Code avoid pre-petition payments to the Internal Revenue Service on account of federal withholding taxes, the court has had an opportunity to analyze portions of the issue in related circumstances. This Court has on no fewer than three occasions examined whether the imposition of a trust pursuant to Section 7501 of the Internal Revenue Code may remove property from a bankruptcy estate. In each case this Court found the imposition of the trust may not be used to remove the property from the debtor. The underlying rationale in these earlier cases should be applied to the case at bar.

In *United States v. Randall,* a case decided under the former Bankruptcy Act, this Court ruled that 26 U.S.C. Section 7501(a) could not be used to impress a trust upon funds held by a bankrupt debtor corporation subsequent to the filing of the bankruptcy petition. *United States v. Randall,* 401 U.S. 513, 91 S.Ct. 991 (1971). The Court found the statutory policy of subordinating taxes to the costs and expenses of administration would not be served by creating or enforcing trusts which eat up an estate leaving little or nothing for creditors and court officers whose goods and services create the assets. *Id.,* 401 U.S. at 516, 91 S.Ct. at 994. The Court ruled that the funds then in the possession of the Debtor could not be found as a trust in favor of the Federal government inasmuch as this claim must succumb to an "overriding statement of Federal policy on questions of priorities." *Id.,* 401 U.S. at 515 91 S.Ct. at 993.

A few years following *Randall,* this Court had another occasion to review 26 U.S.C. Section 7501 in the bankruptcy context. In *U.S. v. Slodov,* this Court ruled that a trust under 26 U.S.C. Section 7501 cannot be impressed on after acquired funds. *United States v. Slodov,* 436 U.S. 238, 98 S.Ct. 1778, 56 L.Ed. 2d. 251 (1978). This Court found that "under Section 7501 there must be nexus between the funds collected and the trust created. That construction is consistent with the accepted principal of trust law requiring tracing of misappropriated trust funds into the trustee's estate in order for an impressed trust to arise". *Slodov, Id.,* 436 U.S. at 256, 98 S.Ct. at 1790 citing to D. Dobbs, *Handbook on the Law of Remedies,* 424-425 (1973). *Randall* and *Slodov* have been cited repeatedly for requiring the

IRS to establish a nexus between the funds withheld from employee's paychecks and the monies held by the employer in order to establish the impressed trust. The failure of the taxing authority to trace this connection precludes the imposition of the trust.

In a case decided under the Bankruptcy Reform Act of 1978, this Court has further ruled that property of the estate includes property of the debtor that had been seized by the Internal Revenue Service prior to the filing of the bankruptcy petition. *United States v. Whiting Pools, Inc.,* 462 U.S. 198, 208-9, 103 S.Ct. 2309, 2315, 76 L.Ed. 2d. 515 (1983). The essence of this Court's ruling in *Whiting Pools* recognized that the taxing authority must protect its interest according to the Congressionally established bankruptcy procedures, rather than, in that case, by withholding seized property from a debtor's efforts to reorganize. *Id.,* 462 U.S. at 212, 103 S.Ct. at 2317.

The Third Circuit differentiated the previous rulings by this Court by emphasizing in its Opinion below that those cases decided under the Act involved transactions in which the IRS was seeking to obtain funds from a debtor post-petition. The Third Circuit believed Congress when enacting the 1978 Bankruptcy Code intended the tracing burden only be applied to funds held as of the commencement of the case. *Begier,* 878 F.2d at 771. This conclusion, however, fails to consider this Court's ruling in *Whiting Pools* which enabled a debtor to recover property which had been seized by the IRS prior to the filing of the petition. While *Whiting Pools* did not turn on the effect of 26 U.S.C. Section 7501, it did express this Court's opinion that the Internal Revenue Service should be treated no differently than any other creditor. To the extent they held a possessory interest, that interest was subjected to the priorities Congress imposed in preserving a bankrupt debtor's property.

The Third Circuit again indicated that it believed the reasoning of the Dissent by Judge Ruth Ginsburg to be more palatable. *Id.* The Dissent in *Drabkin* also distinguished *Randall* as requiring tracing only when a post petition avoidance was at issue. Both Courts referred once more to the Legislative History

which expressly mandated the use of reasonable assumptions should strict tracing not prove possible to determine whether funds in the possession of a debtor as of the commencement of a case were impressed with the trust. *Drabkin, supra.* at P. 1119 quoting 124 Cong. Rec. 32417 (Sept. 28, 1978) (Statement of Representative Edwards); 124 Cong. Rec. 34016-7 (October 5, 1978) (Statement of Senator DeConcini). There is nothing, however, in that same excerpt of the Legislative History which would offer the slightest suggestion that Congress intended its example to be preclusive of any other type of tracing.

In the *Drabkin* Dissent, her Honor questioned the logic professed by the Majority when reaching their conclusion. In an often cited metaphor, her Honor noted that "just as the day follows the night", the Majority's suggestion that the converse to a proposition may not always follow. *Drabkin, supra.* at P. 1119. To limit tracing to post petition transaction, however, her Honor is guilty of using the same faulty logic. Her Honor suggests that if Congress relaxed tracing to establish a trust in a post-petition fund, it may be concluded that Congress did not intend to permit tracing in the pre-petition avoidance scenario. The failure of Congress to hypothesize a pre-petition tracing example is not a legitimate basis to presume it intended to preclude such tracing. This Court's conclusions in *Randall* were not modified by the Bankruptcy Reform Act, they were implemented. The philosophical basis for the *Randall* Decision may be applied to requiring tracing of pre-petitions funds as well as post-petition.

This Court in *Randall* looked at the priorities expressed by Congress between the Bankruptcy Act and the Internal Revenue Code. The Court concluded that the Bankruptcy Act was an overriding statement of Federal policy on the question of priorities. *Randall, supra.* 401 U.S. at P. 516, 91 S.Ct. at 993. This Court noted the progressive legislative development in the Bankruptcy Code marked a decline in the grant of tax preferences to the United States and marked an ascending priority for costs and expenses of bankruptcy administration. *Id.*, 91 S.Ct. at

994.[18] The preference statute under the Act and the Code is only a tool to preserve and enforce the bankruptcy priorities. The purpose of the preference section is to assure equality of distribution among creditors who are similarly situated. *Begier v. Krain Outdoor Advertising,* 68 B.R. 326, 331 (Bkrtcy E.D. Pa. 1988).

While not under a taxing authority's trust fund argument, other Circuit Courts have had occasion to address the issue of whether the transfer sought to be avoided by a trustee was in fact a transfer of property of the estate. The key to the analysis by these Courts is whether the debtor exerted any control over the funds subject to avoidance. The Fifth Circuit in *Coral Petroleum, Inc. v. Banque Paribas-London* noted the argument is prevalent in the "ear marking" context. *Coral Petroleum, Inc. v. Banque Paribas-London,* 797 F.2d 1351, 1356 (5th Cir. 1986). Ear marking occurs when one debt is substituted for another. *Id.* The Court concluded that no preference is created in a transaction of this nature, because the debtor has not transferred property of his estate, he still owes the same sum to a creditor, only the identity of the creditor has changed. *Id.* This is common place where a third person makes a loan to the debtor specifically to enable him to satisfy the claim of the designated creditor. The proceeds never become part of the debtor's assets. *Id.* citing to 4 *Collier on Bankruptcy,* Paragraph 547.25 at P. 547-101-2 (15th Edition 1986).

The Court in *Coral Petroleum* concluded that since at no time did the debtor exert any control over the funds whereby it could not independently designate to whom the money would go, no preference could have resulted. *Id. See also Howdeshell of Fort Meyers v. Dunham-Busch, Inc. In re Howdeshell of Fort Meyers,* 55 B.R. 470, 474-5 (Bkrtcy. N.D. Fla. 1985) (where debtor had absolute control over designation of creditors to be

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18. In 1984, Congress adopted an additional amendment to the Bankruptcy Code which further subordinated the priorities given to taxing authorities under 11 U.S.C. §507(a). Congress permitted farmers and fishermen to have a certain limited priority over the taxing authorities for grain and fish storage facilities. Bankruptcy Amendment and Fed. Judgeship Act, Pub. L. 98-353, Section 350(2), 98 Stat. 333, 358.

paid, payment of creditor by debtor's parent company was the property of the estate under 11 U.S.C. §547). In the case at bar, because the debtor had absolute control over the designation of the payment, it was able to prefer the IRS over its other creditors. This is the exact reason the preference statute was enacted.

The Ninth Circuit, in *Danning v. Bozek,* ruled that property belongs to the debtor for the purposes of §547 if its transfer will deprive the bankruptcy estate of something which could otherwise be used to satisfy the claims of creditors. *Danning v. Bozek, (In re Bullion Reserve of North America)*, 836 F.2d 1214, 1217 (9th Cir. 1988); citing to *Coral Petroleum, supra.* The Ninth Circuit supported its position by emphasizing the underlying purpose to the preference section as being to discourage creditors from racing to the Courthouse to dismember the debtor during its slide into bankruptcy and to further the prime policy of sharing in equal distribution to all similarly situated creditors. *Id. See also Valley Bank v. Vance (In re: Vance)*, 721 F.2d 259, 260 (9th Cir. 1983).

Congress and the Court Opinions expressed above, all attempt to achieve that which the Bankruptcy Code, as a whole, desired as a result. Equal distribution to all similarly situated creditors. The Bankruptcy Code does not allow one creditor, even the Internal Revenue Service, to be preferred over another, except where specifically authorized by the express language.

The effect of the Third Circuit's Opinion would be to deny the ability of a bankruptcy trustee to avoid as preferential transfers any pre-petition payments made to the Internal Revenue Service on account of withholding taxes despite the time when the payment was made or the source of the funds. Such a result was not the contemplation of Congress. The conclusion of the Third Circuit which is based on the Dissenting Opinion in *Drabkin* is erroneous because their ruling is founded on language from the House Report before it was modified by the Floor Managers' Compromise Legislation. The holding of the Majority is based on an invisible statute. If Congress truly intended to impose a restriction on the avoidability by a

bankruptcy trustee of pre-petition payments on account of trust fund taxes, it would have expressly provided for such exemption in the statute.

CONCLUSION

For the foregoing reasons, Petitioner respectfully requests Your Honorable Court to reverse the ruling of the United States Court of Appeals for the Third Circuit and reaffirm the Order of the United States District Court by the Honorable Donald W. VanArtsdalen affirming the Trial Court ruling by the United States Bankruptcy Court.

Respectfully submitted,

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No. 89-393

In the Supreme Court of the United States

OCTOBER TERM, 1989

HARRY P. BEGIER, JR., ETC., PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether an employer's payments of its trust fund tax obligations to the government before it filed a petition in bankruptcy can be avoided as a preference under Section 547 of the Bankruptcy Code.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

Cases—Continued: Page

Cases—Continued: Page

Statutes and regulations:

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BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A2-A20) is reported at 878 F.2d. The opinion of the district court (Pet. App. A22-A26) is unreported. The opinion of the bankruptcy court (Pet. App. A27-A44) is reported at 83 Bankr. 324.

JURISDICTION

The judgment of the court of appeals was entered on June 30, 1989. A petition for rehearing was denied on July 28, 1989. Pet. App. A1. The petition for

a writ of certiorari was filed on September 11, 1989, and was granted on January 8, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This case involves the payment of trust fund taxes made to the government by a corporate debtor during the 90-day period before the debtor filed a petition for relief in bankruptcy. The trust fund taxes are federal income and social security taxes withheld by the corporation from the wages of its employees, as well as transportation excise taxes collected by the corporation from its customers on behalf of the government. See 26 U.S.C. 3102, 3402, 4291. The Internal Revenue Code (26 U.S.C.) provides that those amounts are "held to be a special fund in trust for the United States" that must be paid over to the government. 26 U.S.C. 7501. In this case, the bankruptcy trustee is attempting to recover the debtor's payment of trust fund taxes under Section 547 of the Bankruptcy Code (11 U.S.C.). That provision allows a bankruptcy trustee to avoid as a preference certain payments made out of the debtor's property during the 90-day period before the debtor petitioned for relief in bankruptcy.

1. Petitioner is the trustee in bankruptcy of American International Airways, Inc., which was a commercial airline that provided passenger and air cargo service in the eastern and central United States. By the spring of 1984, American International was delinquent in remitting to the United States both social security and income taxes that it had withheld from the wages of its employees, as well as excise taxes that it had collected from its passengers. On March 1, 1984, the Internal Revenue Service (IRS) notified

the company of its delinquency and required it to file monthly, rather than quarterly, returns of its employment and excise taxes. The IRS also required American International to establish a separate bank account in which to deposit the withholding and excise taxes held in trust for the United States. Pet. App. A4, A29-A30.

Shortly after receiving that notice, American International opened a separate bank account into which it deposited some, but not all, of the excise and employment taxes held in trust for the government. On April 30, 1984, American International paid the IRS $695,000 from its separate trust account and $734,798 from its general operating account. The April payments were followed in June 1984 by two other payments—totalling $211,636—from American International's general account. By agreement with the IRS, the company allocated its payments to specific social security, income withholding, and excise taxes due and collected by American International between 1982 and April 1984. Pet. App. A4, A30-A31, A47-A48.

On July 19, 1984, American International filed a petition for relief under Chapter 11 of the Bankruptcy Code. For the following three months, it attempted to operate as a debtor-in-possession. After that attempt proved futile, the bankruptcy court appointed petitioner as the company's trustee and began liquidation proceedings. Petitioner then brought this adversary proceeding against the government under Section 547 of the Bankruptcy Code to recover as a preference the $1,641,434 in withholding and excise taxes that the company had paid to the IRS in April and June 1984. Pet. App. A4, A27-A28.[1]

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[1] The IRS filed a proof of claim in the Chapter 11 case that sought, among other things, the unpaid portion of withholding

2. The bankruptcy court permitted the trustee to recover from the government a portion of the funds in question. Pet. App. A27-A44. It held that the $695,000 payment made by the company from its segregated trust account was a non-avoidable transfer of funds held in trust for the government under Section 7501 of the Internal Revenue Code; therefore, the bankruptcy court did not allow the trustee to recover those funds. *Id.* at A32. The court ruled, however, that American International's payments of trust fund taxes from the company's general account did not constitute a transfer of funds held in trust for the government. It therefore allowed the trustee to recover most of the payments made from that general account. *Id.* at A32-A44.[2] The court reasoned that trust fund taxes are exempt from the provisions regarding preferential transfers "only where a tax trust fund is actually established by the debtor and the taxing authority is able to trace funds segregated by the debtor in a trust account established for the purpose of paying the taxes in question." *Id.* at A35.

The government appealed to the district court, which affirmed in a decision issued from the bench. Pet. App. A22-A26. Although finding it to be "a very

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taxes for the first quarter of 1984. This preference action involves withholding taxes for the same period. Thus, the government's sovereign immunity with respect to the trustee's action is waived under 11 U.S.C. 106(a). See S. Rep. No. 989, 95th Cong., 2d Sess. 20-30 (1978).

[2] The court held that $246,024 of the amount paid out of the general account was not a voidable preference because it was paid for taxes due less than 45 days before the payment and therefore constituted a non-avoidable payment in the "ordinary course of business." Pet. App. A43-A44. See 11 U.S.C. 547(c)(2) (1982).

close case" (*id.* at A26), the district court concluded that the bankruptcy court correctly held that the payments from the general account should not be treated as having been made out of a trust fund. The district court concluded that the IRS must show at least "some evidence beyond that of merely [the debtor's] having made the payment" in order to establish that payments from commingled corporate funds were actually payments of funds held in trust for the United States. *Id.* at A25.

3. The court of appeals reversed. Pet. App. A2-A20. After reviewing Section 547 of the Bankruptcy Code, the court concluded that Congress regarded "the act of payment of withholding taxes [as] identify[ing] those taxes as funds held in trust" for the government. Pet. App. A16. The court drew a distinction between payments made before bankruptcy (as in this case) and efforts by the IRS to recover funds from a bankruptcy estate. The court noted that, in the latter context, Congress sought to relax the strict tracing of trust fund taxes required in the aftermath of this Court's decision in *United States* v. *Randall*, 401 U.S. 513 (1971). In *Randall*, the Court had refused to allow the government to recover commingled trust fund taxes from a bankruptcy estate. Under the new Bankruptcy Code, the court of appeals held, Congress rejected the *Randall* approach and established the rule that the IRS can use "reasonable assumptions" to trace funds in the bankruptcy estate to withheld taxes belonging to the government. Pet. App. A10-A11. But where the debtor makes payments identified as trust fund taxes before it files a bankruptcy petition, the court held, the government is not required to trace further such trust fund payments back to the actual taxes withheld or collected

by the employer. The court of appeals found that the legislative history of Section 547 demonstrates Congress's intent that monies actually paid by the debtor to meet its trust fund obligations should be regarded, in fact, as the payment of trust taxes. *Id.* at A13-A19. Accordingly, the court concluded that "the debtor's pre-petition payments on account of its tax withholding obligations are held to be a special fund in trust for the IRS for the government under I.R.C. § 7501 and are not preferential transfers of the debtor's property under 11 U.S.C. § 547(b)." *Id.* at A20.

The court of appeals acknowledged that its holding conflicts with *Drabkin* v. *District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987). The court stated that it found "the *Drabkin* dissent convincing" (Pet. App. A13) because the majority in *Drabkin* had misinterpreted the legislative history of Section 547 and had failed to distinguish between a debtor's pre-petition payment of withheld taxes and a post-petition action by the IRS to recover withheld taxes in possession of the bankruptcy estate. See Pet. App. A18-A19. Judge Hutchinson dissented for the reasons set forth by the majority in *Drabkin*. *Id.* at A20.

SUMMARY OF ARGUMENT

1. Section 547 of the Bankruptcy Code allows a bankruptcy trustee to recover certain preferential transfers of the debtor's property that were made before the debtor filed its petition in bankruptcy. Such a transfer can qualify as an avoidable preference only if the property would have been a part of the bankruptcy estate for the benefit of the creditors. And it is clear under Section 541 of the Bankruptcy Code that property held in trust is not available to satisfy the claims on the bankruptcy estate. Hence,

the preference provisions in Section 547 do not reach pre-petition payments of funds held in trust.

2. In this case, American International (the debtor in bankruptcy) withheld federal social security and income taxes from its employees' wages. American International also collected federal excise taxes from the users of its transportation services. Section 7501 of the Internal Revenue Code provides that "the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States." Accordingly, American International's four payments of trust fund taxes to the IRS were payments of funds held in "trust for the United States" and, therefore, may not be reached as preferences under Section 547 of the Bankruptcy Code.

Contrary to petitioner's contention, a trust relationship is not created under Section 7501 only when the collector or withholder of federal taxes places those funds in a separate account with a "trust" label. Section 7501 provides in general terms that the "amount" of funds collected or withheld "shall be held to be a special fund in trust." Thus, as every appellate court that has considered the issue has recognized, the statutory trust relationship is created at the moment the private party withholds or collects the federal taxes.

3. In *United States* v. *Randall*, 401 U.S. 513 (1971), this Court refused to allow the government to recover trust fund taxes from a bankruptcy estate without following the old Bankruptcy Act's rules of priority. The Congress that adopted the Bankruptcy Code in 1978 disapproved *Randall* in two respects. First, Congress made it clear that trust fund taxes do not become a part of a bankruptcy estate for the benefit of creditors. Second, Congress relieved the government from any duty to trace such trust fund

taxes into the bankruptcy estate with precision. Instead, Congress has authorized the government to use reasonable assumptions to identify trust fund taxes.

This case does not involve an attempt by the government to identify trust assets in the bankruptcy estate. At the very least, however, the pre-petition payments at issue cannot qualify as preferences under Section 547 if the funds would not have become part of the estate if the payments had not been made. And the government has plainly used "reasonable assumptions" in concluding that the payments at issue were payments of funds held in trust for the United States. Those payments were: (1) made from American International's general account, (2) made to satisfy American International's obligation to turn over trust fund taxes to the IRS, and (3) identified by American International itself as trust fund taxes. It is surely reasonable for the trust beneficiary to assume that payments identified by the trustee as trust payments are, in fact, trust payments.

Moreover, Congress specifically endorsed the reasonableness of such an approach to pre-petition payments of trust fund taxes. In a passage that fully comports with the text of all pertinent stautory provisions, the relevant House Committee Report on Section 547 stated that a payment of withholding taxes "will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payments." H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977). Here, American International was able to make four pre-petition payments of the trust fund taxes that it had collected or withheld. Hence, as the House Report recognized,

those payments are not preferences that may be recovered by the bankruptcy estate.

ARGUMENT

AMERICAN INTERNATIONAL'S PAYMENTS OF ITS WITHHOLDING AND EXCISE TAX LIABILITIES WERE PAYMENTS OF FUNDS HELD IN TRUST FOR THE UNITED STATES AND, THEREFORE, CANNOT BE RECOVERED FROM THE GOVERNMENT AS PREFERENCES UNDER 11 U.S.C. 547

This is an action against the United States to recover payments of the debtor's trust fund tax liabilities to the IRS that were made before the debtor filed a petition under the Bankruptcy Code. The Third Circuit correctly held that those payments were not preferences under 11 U.S.C. 547 because they were payments of funds held in trust for the United States.

A. Payments Of Funds Held In Trust Are Not Avoidable Preferential Transfers Under 11 U.S.C. 547

1. Section 547 of the Bankruptcy Code allows a bankruptcy trustee to recover certain preferential transfers of "property of the debtor" made before the debtor filed its petition in bankruptcy.[3] The Bankruptcy Code does not define the phrase "property of the debtor."[4] But the fundamental purpose of Sec-

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[3] Section 547 allows a trustee to avoid transfers that were made on or within 90 days before the debtor filed its petition for relief under the Bankruptcy Code. Such an avoidable transfer is called a "preference."

[4] Section 462(b) of the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 378 (1984 Act) substituted for the phrase "property of the debtor" in Section 547(b) the phrase "an interest of the debtor in property." Although the legislative commentary on the 1984 Act does not explain the amendment, it is described by the

tion 547 is to preserve the "property of the estate" (11 U.S.C. 541(a))) for the benefit of creditors. As a starting point, therefore, the courts have consistently looked to the definition of estate property in Section 541 as guidance for the type of property that may be recovered as a preference under Section 547. See *Drabkin* v. *District of Columbia*, 824 F.2d 1102, 1104 & n.8 (D.C. Cir. 1987); *Elliott* v. *Frontier Properties/LP (In re Lewis W. Shurtleff, Inc.)*, 778 F.2d 1416, 1419 (9th Cir. 1985); *Perry* v. *General Motors Acceptance Corp.* (*In re Perry*), 48 Bankr. 591, 599 n.14 (Bankr. M.D. Tenn. 1985). If transferred property is not the type of property that would have become property of the estate for the benefit of creditors, it may never be recovered under Section 547(b). See *Drabkin* v. *District of Columbia*, 824 F.2d at 1104-1105; *Clark* v. *Mutual Lumber Co.*, 206 F.2d 643, 646-647 (5th Cir. 1953). See also 4 L. King, *Collier on Bankruptcy* ¶ 547.03[2] (15th ed. 1989) ("A transfer is preferential only if the property or the interest in property transferred belongs to the debtor.").

2. A debtor's mere possession of certain property does not mean that such property is available in the bankruptcy estate for the benefit of creditors. For example, no one doubts that creditors of an insolvent dry cleaner may not satisfy their claims by recovering as preferences the clothes that were picked up by patrons soon before the cleaner filed its petition in

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Senate Report introducing a predecessor bill as a "clarifying change." S. Rep. No. 65, 98th Cong., 1st Sess. 81 (1983), commenting on S. 455, 98th Cong., 1st Sess. § 359(b) (1983). The amendment is effective as to cases filed 90 days after the enactment of the 1984 Act (§ 553(a), 98 Stat. 392), and is therefore not applicable to this case, which was filed on July 19, 1984.

bankruptcy. Nor could creditors of a parking garage recover for the bankruptcy estate the cars that were returned to their owners in the days before the garage filed a bankruptcy petition. See *Collier on Bankruptcy, supra*, ¶ 547.03; Jackson, *Statutory Liens and Constructive Trusts in Bankruptcy; Undoing the Confusion*, 61 Amer. Bankr. L.J. 287, 290 (1987).

It is equally well settled that, by virtue of Section 541(d) of the Bankruptcy Code, property held by the debtor in trust for another does not become a part of the bankruptcy estate for the benefit of creditors. As the Court noted in *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198, 204 n.8 (1983), under Section 541 of the Bankruptcy Code, "Congress intended to exclude from the estate property of others in which the debtor had some minor interest such as a lien or bare legal title." [5] See also S. Rep. No. 1106, 95th Cong., 2d Sess. 33 (1978) ("amounts held by the debtor as trustee for another are not property of the estate"); 124 Cong. Rec. 34,016-34,017 (1978) (statement of Sen. DeConcini) ("property of the estate does not include the beneficial interest in property held by the debtor as trustee"); *id.* at 32,399 (statement of Rep. Edwards).[6] Accordingly, all courts have agreed that

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[5] Section 541(d) of the Bankruptcy Code would allow recovery of a debtor's legal title to funds held in trust. But petitioner does not seek such legal title; he wants the money at issue to be paid by the government to the estate so it will be available to satisfy the claims on the estate.

[6] Although there were substantial differences between the House and Senate versions of the proposed Bankruptcy Code, time constraints prevented the preparation of a conference committee report reconciling those differences. Instead, the principal congressional sponsors of the statute, Representative Don Edwards and Senator Dennis DeConcini, made oral reports to Congress on the results of the closed-door confer-

a pre-petition transfer of funds held in trust may not be recovered by the estate as a preference. See Pet. App. A14-A15; *Drabkin* v. *District of Columbia*, 824 F.2d at 1107. That rule applies with equal force where, instead of a private instrument, it is a "statutory provision[] * * * that creates a trust fund." 124 Cong. Rec. 32,399 (1978) (statement of Rep. Edwards).

The precise question in this case, therefore, is whether American International's 1984 payments to the IRS were payments of funds held in trust for the government. A natural reading of the relevant provisions of the Internal Revenue and Bankruptcy Codes, as well as legislative history pertaining to this precise matter, lead to the same conclusion—the payments at issue were properly treated as non-avoidable payments of trust fund taxes.

B. The "Amount Of Tax" That American International Withheld And Collected Was Held In Trust For The Government

1. Beginning in the 1930s, the federal government has increasingly used private businesses and employers to collect federal taxes. See Note, *The Private Tax Collector—A New Fiduciary*, 60 Harv. L. Rev. 786 (1947). This case involves such a collection method for three federal taxes. Sections 3102 and 3402 of the Internal Revenue Code require that an employer withhold federal income taxes and Federal

ences. See 124 Cong. Rec. 32,350, 32,391, 32,392 (1978) (statement of Rep. Edwards); *id.* at 33,989, 33,990 (statement of Sen. DeConcini). See generally, Klee, *Legislative History of the New Bankruptcy Code*, 28 De Paul L. Rev. 941 (1979). This Court has viewed those floor statements as persuasive evidence of Congress's intent. See, *e.g.*, *CFTC* v. *Weintraub*, 471 U.S. 343, 351 (1985).

Insurance Contribution Act (FICA) taxes from its employees' wages. The withheld tax is "owed" exclusively by the employee; thus the employee, and not the employer, is entiteld to a refund or credit if the employer withholds an excessive amount. See Treas. Reg. § 31.6402(a)-2(a)(2) and (b) (26 C.F.R.). A similar scheme governs the payment of excise taxes for transportation services, which are collected by the party providing such services. See 26 U.S.C. 4291.

A withholding of taxes under Sections 3102 and 3402 occurs whether or not the employer physically deposits withheld income and FICA taxes in a separate "withholding" account when it pays its employees' wages. The Senate Finance Committee has given a simple example. It stated that, if an employer owes $100 in wages, and pays the employee $80, then "there has been $20 withheld." S. Rep. 1106, 95th Cong., 2d Sess. 33 (1978).[7] Employers are required to make periodic deposits of withholding taxes with designated depositaries. See Treas. Reg. § 31.6302(c)-1 (26 C.F.R.). Collectors of excise taxes are required to make similar periodic deposits. See Treas. Reg. § 49.6302(c)-1 (26 C.F.R.). The time for making such deposits depends upon various factors—*e.g.*, the size of the withholding and the timing of the employers' pay period. In general, however, deposits into the accounts of the United States Treasury are not made at the same time the taxes are withheld or collected. See *Slodov* v. *United States*, 436 U.S. 238, 243 (1978).

If the collector of excise, FICA, or withholding taxes fails to turn the money over to the government,

[7] Likewise, a transportation entity collects $20 in transportation excise taxes when a passenger pays it $100 for a ticket that costs $80.

the government has no recourse against the taxpayer. Excise taxes cannot be collected twice, and withheld taxes are "credited to the employee regardless of whether they are paid by the employer." *Slodov* v. *United States*, 436 U.S. at 243; see, *e.g.*, Treas. Reg. § 1.31-1(a) (26 C.F.R.). The government's receipt of taxes collected or withheld by employers (and others) is thus at risk by virtue of the time gap between collection and deposit into a designated agent of the Treasury. As the Court observed in *United States* v. *Sotelo*, 436 U.S. 268, 277 n.10 (1978):

> [i]t is a common phenomenon of business failure that even an "honest" businessman, in attempting to salvage a business which appears headed for insolvency, will frequently "borrow" money of other people without their consent if he can get his hands on it. The one fund which he is almost always able to lay his hands on is the taxes he has withheld and is currently withholding from his employees for the Government.

See also *Slodov* v. *United States*, 436 U.S. at 243.

Congress addressed that concern in 1934 by creating a statutory trust relationship between the collector of federal excise taxes and the government. See § 607 of the Revenue Act of 1934, ch. 277, 48 Stat. 768. In 1939, Congress extended the statutory trust provision to cover all withheld or collected taxes. See 53 Stat. 448. The statutory trust provision is currently codified as Section 7501 of the Internal Revenue Code. Section 7501 provides:

> Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States.

The Senate Committee that recommended enactment of the predecessor to Section 7501 explained its purpose and effect:

> Existing law provides with respect to a number of taxes that the amount of the tax shall be collected or withheld from the person primarily liable by another person, who is required to return and pay to the Government the amount of the taxes so collected or withheld by him. This is true, for example, in the case of the taxes on admissions, checks, and telephone and telegraph services. Under existing law the liability of the person collecting and withholding the taxes to pay over the amount is merely a debt, and he cannot be treated as a trustee or proceeded against by distraint. Section 606 of the bill as reported impresses the amount of taxes withheld or collected with a trust and makes applicable for the enforcement of the Government's claim the administrative provisions for assessment and collection of taxes.

S. Rep. No. 558, 73d Cong., 2d Sess. 53 (1934); see also H.R. Conf. Rep. No. 1385, 73d Cong., 2d Sess. 32 (1934).

Thus, Section 7501 establishes beyond doubt that the amounts of taxes withheld by a third party are not merely debts of the withholder; such amounts "shall be held to be a special fund in trust for the United States." As the court succinctly observed in *Kalb* v. *United States*, 505 F.2d 506, 509 (2d Cir. 1974), cert. denied, 421 U.S. 979 (1975), "[i]n paying taxes over to the government the employer merely

surrenders that which does not belong to him." See also *Newsome* v. *United States*, 431 F.2d 742, 745-746 (5th Cir. 1970). If the employer fails to turn over funds held in trust, then the government may "treat" the employer "as a trustee" and "proceed[] against [the funds] by distraint." S. Rep. No. 558, *supra*, at 53. See also *In re Allied Elec. Products, Inc.*, 194 F. Supp. 26, 30-31 (D.N.J. 1961).

In this case, American International made four relevant payments to the IRS of collected and withheld trust taxes. Pet. App. A4. Those funds, by operation of Section 7501, were "a special fund in trust for the United States." And American International agreed that its four payments were made to satisfy its obligation to turn over trust fund taxes to the government (as opposed to American International's own tax debts owed to the government). Accordingly, American International's payments of trust funds to the proper beneficiary—the United States—falls within the well-recognized rule that pre-petition payments of trust funds may not be recovered by the bankruptcy estate as preferential transfers under 11 U.S.C. 547.

2. We understand petitioner to agree with much of our analysis to this point. Petitioner does not now claim that American International's payment of $695,000 from the separate "trust" account was a preferential transfer. That is so, in petitioner's view, because the $695,000 came from a segregated account, not the company's general account. In other words, petitioner's main argument (Br. 19-21) is that a trust for the benefit of the United States is created under Section 7501 only if the withheld or collected taxes are placed in a separate "trust" account. Petitioner's formalistic position, however, finds no support

in the language of the statute, the IRS regulations, or the relevant case law.[8]

Section 7501 is written in general terms, with no suggestion that a trust is created only if the withheld or collected taxes are placed in a separate account with a "trust" label before they are turned over to the government. It provides that "the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States." The words "shall be held to be" mean that a trust in the "amount" of taxes withheld or collected is created by operation of law; a trust is not dependent upon or created by an employer's deposit of funds into a bank account labeled "trust account."[9] Thus, as the Court stated in *Slodov* v. *United States*, 436 U.S. at 243, "[t]here is no general requirement [in Section 7501] that the withheld sums be segregated from the employer's general funds * * * or that they be deposited in a separate bank

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[8] Petitioner also errs in describing this case as one involving a question of priorities. Petitioner points to the "ascending priority for costs and expenses of bankruptcy administration" (Br. 24), and concludes that "the Internal Revenue Service should be treated no differently than any other creditor." Br. 23. This case, however, does not involve questions of priorities in a pool of funds but, rather, whether that pool may be expanded by trust fund taxes previously paid to the IRS. Although Congress has made clear that costs and expenses of administration are to have priority in bankruptcy, 11 U.S.C. 507, it has never stated any intention to force the IRS to turn over trust fund taxes to underwrite those costs and expenses.

[9] This is also implied by Section 7501's statement that a trust is created in "the amount of tax so collected or withheld." The "res" of the trust is thus an abstract "amount"—not a tangible collection of money in a designated trust account.

account until required to be paid to the Treasury." [10] See also Treas. Reg. § 31.6302(c)-1 (26 C.F.R.).[11] Consequently, if an employer fails to pay over withheld taxes, the IRS may levy on the employer's bank accounts, see 26 U.S.C. 6331-6344, and it is no defense for the employer to say that its account does not contain the same "funds" that were withheld as taxes. See generally *In re Gotham Provisions Co.*, 669 F.2d 1000, 1011 (5th Cir. 1982).

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[10] *Slodov* involved the question whether a corporate officer was subject to the "one hundred percent penalty" of 26 U.S.C. 6672 for his failure to use after-acquired funds to pay withholding taxes that had become delinquent before he gained control of the corporation. Reasoning that Congress had not intended Section 6672 to impose liability without fault, the Court held that the trust created by Section 7501 attached only to funds that had some nexus to the taxes withheld. 436 U.S. at 253-256. *Slodov* did not address the question of *how* that nexus could be established in a case involving 26 U.S.C. 7501 and Section 547 of the new Bankruptcy Code.

[11] If an employer fails to carry out its responsibilities to collect, account for, and pay over the trust fund taxes in a timely fashion, the IRS can require the employer to establish a separate tax account, as it did here. See 26 U.S.C. 7512. Section 7501, however, does not make the existence of the trust dependent upon the creation of a separate account. Petitioner errs in asserting (Br. 19-20 n.15) that Section 31.6302(c)-1 (26 C.F.R.) requires segregation of trust funds. Both that Section and Section 49.6302(c)-1 concern the *payment* of trust funds to designated financial agents of the government, not the establishment of a trust. It is illogical to suppose, as does petitioner (Br. 10), that "[t]he failure to pay these monies into an established tax depository bars the creation of the trust mandated by §7501." Once trust fund taxes are so deposited, they are under the control of the government and there is no longer any need for the trust provision contained in Section 7501.

Petitioner's claim that Congress implicitly intended to require a segregated trust account is also inconsistent with the purpose of Section 7501. As we explained above, Congress enacted Section 7501 to give the government a powerful new tool in receiving taxes collected by third parties. But there was no hint that the new tool—*i.e.*, the statutory trust—was dependent on the third party's opening and making deposits in an actual "trust fund" account in a financial institution.

An employer withholds taxes when it pays its employees less than they are due in wages. See p. 13, *supra*. There is no check or cash delivered from the employee to the employer. Hence, the effect of the withholding on the employer's general bank account is simply to reduce what would otherwise be paid out in wages. There is no tangible "res" that must be deposited somewhere; rather, the employer must only make an accounting notation in its books. Thus, "it is hard to conclude that Congress, having determined that, as additional protection for the Government, [withheld or collected] funds should be held in trust, simultaneously devitalized that provision by hinging its effectiveness upon the employers' method of" keeping accounts. Heffron, *Fraud in Withholding*, 18 N.Y.U. Inst. on Fed. Tax'n 1073, 1076 (1960). Accordingly, Congress and the courts have consistently ruled that Section 7501 imposes a trust on the amounts of withheld and collected taxes even if those amounts are part of a general business account including funds from several sources. See Pet. App. A10-A11; see also 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards); *id.* at 34,017 (statement of Sen. DeConcini).[12]

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[12] Even the District of Columbia Circuit in *Drabkin* v. *District of Columbia*, *supra*, recognized that deposits into a sep-

C. The Payments In This Case, Which Were Identified By American International As Trust Fund Taxes, Were Properly Treated As Trust Payments Under Section 547 Of The Bankruptcy Code

1. Although Section 7501 does not require a separate trust fund account, we do not suggest that there need be no nexus between the amounts of withheld or collected taxes and the statutory trust fund. Cf. *Slodov* v. *United States*, 436 U.S. at 256. Over the years, the courts have used a considerable array of rules to establish such a connection between the original source of a trust fund and property that is later used to satisfy the trustee's obligations to the beneficiary. Such rules—often called "tracing" rules —have varied widely depending on the context and reasons for the trust. See G. Bogert, *The Law of Trusts and Trustees* §§ 921-930 (2d ed. 1982).

One tracing rule employed by courts in the setting of traditional trusts created by private instruments is the so-called "swollen asset" doctrine. See G. Bogert, *The Law Of Trusts and Trustees*, *supra*, § 922. That rule essentially allows a trust beneficiary to trace trust funds into the trustee's general accounts. The rule is premised on the notion that the trustee's unauthorized use of trust funds relieved it of using non-trust asests and thus "swelled" the trustee's other accounts. See, *e.g.*, *Schumacher* v. *Harriett*, 52 F.2d 817, 819 (4th Cir. 1931) (collecting cases); *Edwards* v. *Lewis*, 98 Fla. 956, 966-969, 124 So. 746, 749-750 (1929); *Eastman* v. *Farmers' State Bank*, 175 Minn. 336, 339-340, 221 N.W. 236, 237 (1928). The Congress that adopted the Bankruptcy Code endorsed that tracing rule in a context

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arate account were not needed to create a trust relationship under Section 7501. See 824 F.2d at 1116.

different from this case—where the debtor did *not* make its payment of trust fund taxes *before* it filed a bankruptcy petition and the government seeks to recover such funds from the bankruptcy estate. To understand how Congress reached that conclusion, however, it is necessary first to return to the case of *United States* v. *Randall*, 401 U.S. 513 (1971).

In *Randall*, the district court had ordered the debtor to pay withheld taxes into a special account, but the debtor had failed to comply. When the debtor was later adjudged bankrupt, the United States sought to recover the amount of the withheld taxes ahead of the payment of costs and expenses of administration of the bankruptcy proceedings. This Court, however, held that Section 64(a)(1) of the old Bankruptcy Act, which gave first priority to the costs and expenses of administering a bankruptcy estate, constituted an "overriding statement of federal policy on this question." 401 U.S. at 515. The Court therefore concluded that enforcement of the trust created by Section 7501 "would run counter to the grain of the Bankruptcy Act." *Id.* at 517.

In applying *Randall* in cases arising under the Bankruptcy Act, the lower courts placed heavy or insurmountable burdens upon the IRS when it sought to recover trust fund taxes from a bankruptcy estate. Some courts interpreted *Randall* to mean that, in order to establish that funds held by the bankruptcy estate were trust funds, the IRS was required to trace rigorously such funds to monies actually withheld for the payment of the taxes at issue. See, *e.g.*, *In re Rohar Associates, Inc.*, 375 F. Supp. 637 (S.D.N.Y. 1974). The Ninth Circuit refused to recognize trusts even when such tracing was possible. See *England* v. *United States (In re Shakesteers Coffee Shops)*, 546 F.2d 821 (1976); *Rothman* v.

United States (In re Tamasha Town and Country Club), 483 F.2d 1377 (1973).

Congress was aware of that situation in 1978 when it adopted the new Bankruptcy Code. See 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards); *id.* at 34,017 (statement of Sen. DeConcini); S. Rep. No. 1106, *supra*, at 33 & n.25. And Congress made clear that it was disapproving both of those readings of *Randall*. Congress drafted the new Bankruptcy Code so that: (1) trust fund taxes do not become a part of a bankruptcy estate for the benefit of creditors, and (2) the IRS is not required to trace trust fund taxes with precision.

a. As we explained above, Section 541(d) of the Bankruptcy Code excludes from the definition of "estate property" all property in which the debtor holds "only legal title and not an equitable interest." In other words, Congress rejected the notion that, by commencing bankruptcy proceedings, the debtor could enlarge his rights in property by acquiring beneficial use of funds previously held only in trust. See H.R. Rep. No. 595, *supra*, at 367-368; S. Rep. No. 989, *supra*, at 82. See also 124 Cong. Rec. 32,399 (1978) (statement of Rep. Edwards); *United States* v. *Whiting Pools, Inc.*, 462 U.S. at 204 n.8.

The Senate passed a version of Section 541 that explicitly excluded from the estate all taxes witheld or collected from others before commencement of the case. See S. 2266, 95th Cong., 2d Sess. (1978). The Senate Report emphasized that this included "taxes withheld or collected by the debtor from others," and that "[t]his rule supersede[d] cases holding that withheld amounts are property of the estate." S. Rep. No. 1106, *supra*, at 33 & n.25. Congress deleted that provision in the Senate Bill only because Congress believed it was "unnecessary since property of the

estate does not include the beneficial interest in property held by the debtor as a trustee. Under the Internal Revenue Code of 1954 (section 7501), the amounts of withheld taxes are to be a special fund in trust for the United States." 124 Cong. Rec. 34,016-34,017 (1978) (statement of Sen. DeConcini); see also *id.* at 33,999 (Section 541 will not "affect various statutory provisions * * * that creates [*sic*] a trust fund for the benefit of creditors") (statement of Sen. DeConcini); *id.* at 32,399 (statement of Rep. Edwards). See *Drabkin* v. *District of Columbia*, 824 F. 2d at 1114; *Selby* v. *Ford Motor Co.*, 590 F.2d 642, 648 n.18 (6th Cir. 1979); *Schifter* v. *First Fidelity Financial Services, Inc.* (*In re First Fidelity Financial Services, Inc.*), 36 Bankr. 508, 513 (Bankr. S.D. Fla. 1983); *Olsen* v. *Deutscher (In re Nashville White Trucks, Inc.)*, 22 Bankr. 578, 587 n.12 (Bankr. M.D. Tenn. 1982).

b. Congress also disapproved the strict tracing requirements that some courts had adopted in *Randall*'s wake. The joint floor statements addressed the situation where the government attempts, after a petition for bankruptcy relief has been filed, to recover trust fund taxes that have been commingled with other funds:

> Where it is not possible for the Internal Revenue Service to demonstrate that the amounts of taxes withheld are still in the possession of the debtor at the commencement of the case, present law generally includes amounts of withheld taxes as property of the estate. *See, e.g., United States* v. *Randall*, 401 U.S. 513 (1973) and *In re Tamash Town and Country Club*, 483 F. 2d 1377 (9th Cir. 1973). Nonetheless, a serious problem exists where "trust fund taxes" withheld from others are held to be property of the estate where the withheld amounts are commingled with other

> assets of the debtor. The courts should permit the use of reasonable assumptions under which the Internal Revenue Service, and other tax authorities, can demonstrate that amounts of withheld taxes are still in the possession of the debtor at the commencement of the case. For example, where the debtor had commingled that amount of withheld taxes in his general checking account, it might be reasonable to assume that any remaining amounts in that account on the commencement of the case are the withheld taxes.

124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards); *id.* at 34,017 (statement of Sen. DeConcini); see also S. Rep. No. 1106, *supra*, at 33.

Accordingly, the courts of appeals have agreed that Congress, in enacting the Bankruptcy Code, intended to permit the government to use "reasonable assumptions" to identify and recover trust fund taxes that are included in the commingled funds of a bankruptcy estate. See Pet. App. A11, A19; *Drabkin* v. *District of Columbia*, 824 F.2d at 1115. One such assumption is essentially the "swollen asset" doctrine (see p. 20, *supra*)—*i.e.*, in the absence of contrary evidence, "any remaining amounts" in the debtor's general "account on the commencement of the case are the withheld taxes." 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards); *id.* at 34,017 (statement of Sen. DeConcini).

To be sure, this case does not involve the government's attempt to identify trust assets in the bankruptcy estate. At the very least, however, the payments at issue in this case cannot be reached as preferences under Section 547 if the funds would not have become part of the estate if the payments had not been made. See pp. 10-11, *supra*. And there can be little doubt that the government has used "reasonable assumptions" in concluding that the payments at issue in this case were payments of trust fund taxes. The payments were made from American International's general operating account. The payments were made to satisfy its obligation to turn trust fund taxes over to the IRS. And, significantly, American International itself identified the payments as trust fund taxes.[13] If this case involved a traditional private trust that began with an identifiable and tangible res, it would be reasonable to assume that the funds remaining in American International's general account were linked to trust property. See p. 20, *supra*. Thus it is surely reasonable for the IRS to assume that payments identified as trust fund taxes—which were originally collected by notations in American International's books—are exactly what they purport to be: payments of trust fund taxes that were held by American International for the benefit of the United States.

2. Indeed, the Court does not have to judge for itself whether the government reasonably may treat pre-petition payments due and identified as trust fund taxes as such—trust payments. Congress, in adopting Section 547 of the Bankruptcy Code, specifically endorsed the reasonableness of such an approach to payments made to the government before a debtor files a bankruptcy petition.

Section 547 of the Bankruptcy Code—the preference provision—originated in the House of Representatives. See H.R. 8200, 95th Cong., 1st Sess. § 547 (1977).

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[13] Accordingly, this case does not present the question of how (or whether) the IRS must trace trust fund taxes when it seizes an employer's assets. See, *e.g.*, *United States* v. *Daniel (In re R & T Roofing Structures & Commercial Framing, Inc.)*, 887 F.2d 981 (9th Cir. 1989).

The House Committee on the Judiciary's Report accompanying H.R. 8200 has been viewed by this Court as authoritative evidence of Congress's intent. See, *e.g.*, *Northwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 208 (1988) (relying on House Report's definition of "property"); *United Savings Ass'n* v. *Timbers of Inwood Forest Associates*, 484 U.S. 365, 372 (1988); *Ohio* v. *Kovacs*, 469 U.S. 274, 279 (1985). And the House Report pertaining to Section 547 specifically addressed the pre-petition payment of trust fund taxes.[14] It stated:

> A payment of withholding taxes constitutes a payment of money held in trust under Internal Revenue Code § 7501(a), and thus *will not be a preference* because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payments.

H.R. Rep. No. 595, *supra*, at 373 (emphasis added).

The thrust of what Congress intended "comes across without static: if the debtor is able to make the payment, the taxes 'have been properly held for payment,'" and thus such trust fund payments may not

[14] Petitioner errs in claiming (Br. 12-17) that the House Committee Report refers to statutory language that was not enacted. No court that has addressed the issue, including the District of Columbia Circuit in *Drabkin*, has reached petitioner's surprising conclusion. In fact, the House version of Section 547(b), which is discussed in H.R. Rep. No. 595, was ultimately enacted. Compare H.R. 8200, 95th Cong., 1st Sess. § 547 (1977). The much broader Senate version of Section 547, which excluded from preference treatment *all* pre-petition tax payments and not simply trust fund payments, was not passed. See 124 Cong. Rec. 32,400 (1978) (statement of Rep. Edwards); *id.* at 34,000 (statement of Sen. DeConcini).

be reached as preferences under Section 547. *Drabkin* v. *District of Columbia*, 824 F.2d at 1118 (R.B. Ginsburg, J., dissenting). See also Pet. App. A18; *Pereira* v. *United States (In re Rodriguez)*, 50 Bankr. 576, 581 (Bankr. E.D. N.Y. 1985) ("the House Report on § 547(b) recognized that where the debtor was able to make the withholding tax payments as evidenced by his delivery of the funds to the IRS, the monies should be labeled trust funds and the debtor's duty as trustee regarded as completed"); *Razorback Ready-Mix Concrete Co.* v. *United States (In re Razorback Ready-Mix Concrete Co.)*, 45 Bankr. 917, 922 (Bankr. E.D. Ark. 1984) ("if the debtor was able to make the payments, designated the payments as 'taxes due' *and* delivered the payments to the government, the monies could be labeled trust funds and the debtor's duty as trustee was accomplished").

This express intent of Congress is readily understandable in light of the policies underlying Section 547 of the Bankruptcy Code and Section 7501 of the Internal Revenue Code.[15] Congress and this Court have noted that a struggling business may be tempted to fulfill its trust fund obligations only after it pays its other bills, a problem Congress sought to address with Section 7501. See, *e.g.*, H.R. Rep. No. 595, *supra*, at 193. Congress further recognized the likelihood that a business will commingle trust funds with other funds. See, *e.g.*, 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards); *id.* at 34,017 (state-

[15] Petitioner argues (Br. 18) that, if Congress had meant to exclude pre-petition payments identified as trust fund taxes from Section 547, it would have done so explicitly. This proves too much; one could just as easily say that, had Congress meant to require strict tracing or a segregated trust account, it would have done so explicitly.

ment of Sen. DeConcini). Congress has not prohibited such commingling, but it would be illogical to think that Congress intended the debtor's identification of trust funds to be questioned when the debtor avoids the temptation to dissipate trust fund taxes and actually pays over such amounts to the IRS. This is particularly true given that the government's collection of trust fund taxes—which were originally paid by the employee or the transportation user—does nothing to undermine the central goal of the preference provision in the Bankruptcy Code to prevent a struggling enterprise from unfairly favoring one of its creditors. See generally *Collier on Bankruptcy*, *supra*, ¶ 547.01, at 547-11 to 547-13. For these reasons, it was eminently sensible for Congress (as the House Report explicitly stated) to exclude pre-petition payments that are identified as trust fund taxes from the preference provisions of Section 547.

3. Petitioner relies heavily (Br. 13-18) on the majority opinion in *Drabkin* v. *District of Columbia*, *supra*. In that case, the majority held that certain pre-petition payments of trust fund taxes could be recovered by the bankruptcy estate because the local government could not adequately trace the taxes. For the reasons we have explained above, however, *Drabkin* was wrongly decided. The majority in *Drabkin* misread the plain meaning of the House Report on Section 547; specifically, the panel failed to distinguish between a business's trust fund obligations and a business's own tax liabilities, such as corporate income taxes.[16]

[16] The *Drabkin* majority also reasoned that the House Report's passage concerning trust fund taxes was in the wrong place to support the government's position. The majority stated that "we would expect to find the passage in its commentary on section 541, which defines what property is included in the debtor's estate." *Drabkin* v. *District of Columbia*, 824 F.2d at 1112. We disagree. It was quite natural for the House to discuss preferences in its report addressing Section 547—the section setting forth the preference provisions.

The *Drabkin* majority began by correctly noting that Congress intended that some pre-petition tax payments could be avoided as preferences. That is clear from the fact that Congress ultimately rejected the Senate proposal that would have eliminated all tax payments from the reach of Section 547. See 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards); *id.* at 34,016 (statement of Sen. DeConcini). What the *Drabkin* majority failed to recognize, however, was that Congress consistently distinguished between taxes collected or withheld by the debtor (*i.e.*, taxes held in trust for the government) and taxes incurred by the debtor itself. See, *e.g.*, 124 Cong. Rec. 33,999-34,000 (1978) (statement of Sen. DeConcini); H.R. Rep. 595, *supra*, at 191-192; S. Rep. 989, *supra*, at 14; S. Rep. No. 1106, *supra*, at 33. Thus, the *Drabkin* majority is correct in its view that the House Report on Section 547(b) (H.R. Rep. No. 595, *supra*, at 373) shows that *some* tax payments might be avoidable preferences. But the notion that some pre-petition tax payments may be subject to avoidance as preferences does not support the conclusion that the payments of *trust fund* taxes may be avoided.

Accordingly, as the court of appeals recognized in this case (Pet. App. A18), non-trust fund taxes, such as corporate income taxes, Federal Unemployment Tax Act taxes, and the employer's share of FICA taxes, may be recovered by the bankruptcy estate under Section 547(b). By contrast, pre-petition payments of trust fund taxes are not transfers of the debtor's property that can be recovered

as preferences under Section 547. This is the view stated in the House Report (p. 26, *supra*); and, as we have explained, that view fully comports with the text of all pertinent statutory provisions and with the logic of Congress's undertaking in the Bankruptcy Code to limit the effect of this Court's decision in *Randall*.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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